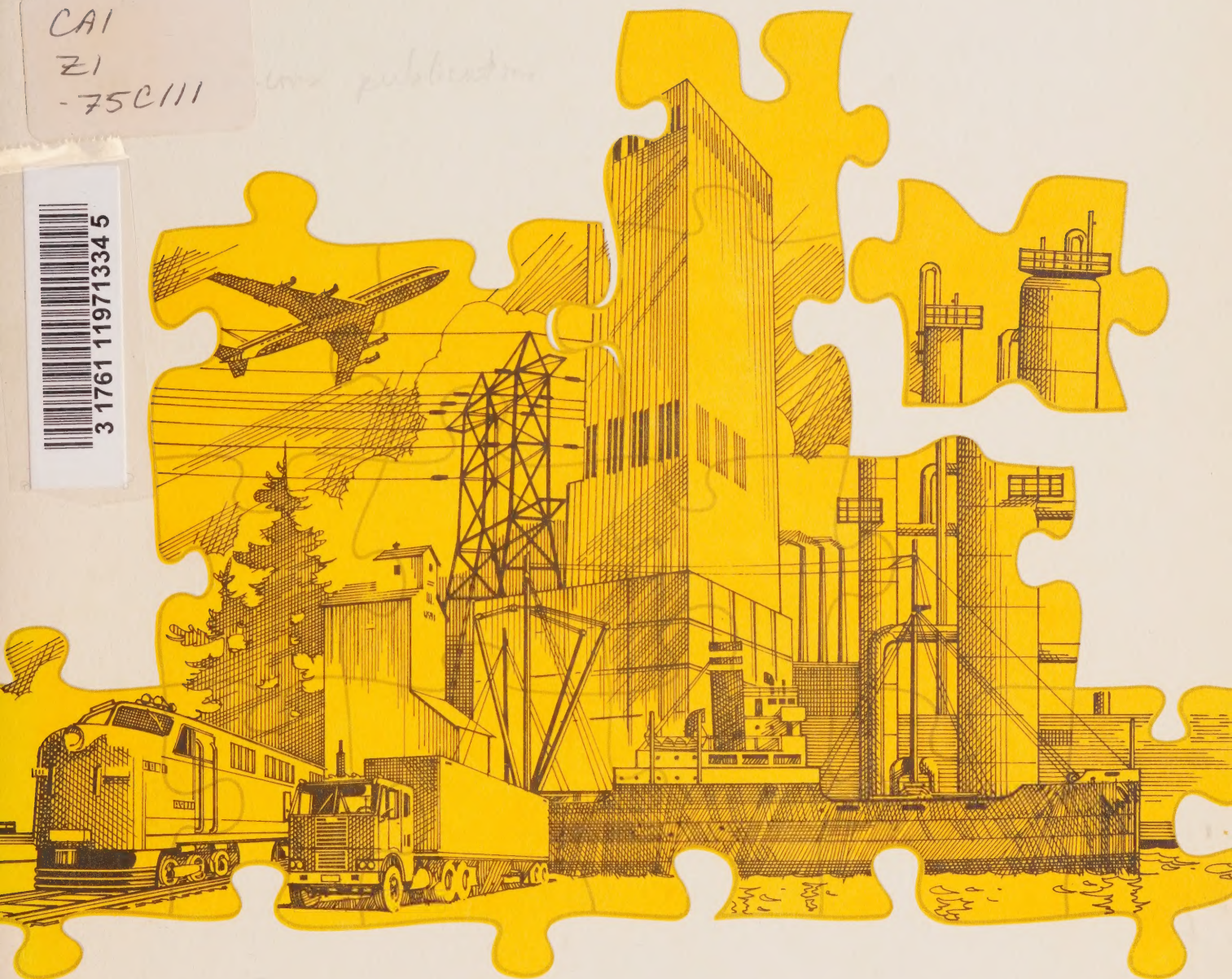


Royal Commission on Corporate Concentration

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STUDY NO. 11

**Rothmans of Pall Mall Canada Limited
& Carling O'Keefe Limited**

A Corporate Background Report



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Study No. 11

Rothmans of Pall Mall Canada Limited

and

Carling O'Keefe Limited

A Corporate Background Report

by

Robert G. Shoniker

June 1977



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FOREWORD

In April 1975 the Royal Commission on Corporate Concentration was appointed to "inquire into, report upon, and make recommendations concerning:

- (a) the nature and role of major concentrations of corporate power in Canada;
- (b) the economic and social implications for the public interest of such concentrations; and
- (c) whether safeguards exist or may be required to protect the public interest in the presence of such concentrations."

To gather informed opinion, the Commission invited briefs from interested persons and organizations and held hearings across Canada beginning in November 1975. In addition, the Commission organized a number of research projects relevant to its inquiry. One such project resulted in a series of studies, of which this is one, dealing with the growth of large and diversified corporations in Canada. The series was coordinated by Charles B. Loewen of Loewen, Ondaatje, McCutcheon & Co. Ltd., an investment firm in Toronto.

This report on ROTHMANS OF PALL MALL CANADA LIMITED AND CARLING O'KEEFE LIMITED was prepared by Robert G. Shoniker, who, in providing security analysis, has followed both the beverage and tobacco industries for a number of years. Mr. Shoniker, who has his MBA from Queen's University at Kingston and a marketing background, entered the investment industry in 1970.

The Commission is publishing this and other background studies in the public interest. However, the analyses presented and conclusions reached in each study are those of the author, and do not necessarily reflect the views of the Commission or its staff.

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CHAPTER 1

INTRODUCTION

Rothmans of Pall Mall Canada Limited (RPM) and Carling O'Keefe Limited have been associated since 1968 when 11% of Carling O'Keefe Limited (then Canadian Breweries Limited) was acquired by RPM from the Argus Corporation.

The first chapter of this study is intended to provide a general background for a consideration of the two companies, first by reviewing RPM's affiliations with the multinational organization to which it belongs, then by analyzing the relationship between RPM and Carling O'Keefe, and, finally, by comparing their performance over the past five years. Chapters 2 and 3 will describe each company in turn so as to highlight events in their separate histories.

ROTHMANS OF PALL MALL CANADA LIMITED: AFFILIATIONS WITH ROTHMANS GROUP

Rothmans of Pall Mall Canada Limited (RPM) is controlled by Rothmans of Canada Limited (ROC), which owns 3,800,000 shares (83.4%), and Rupert Group Holdings Soc. An., Luxembourg, owner of 98,803 shares (2.1%). Rothmans of Canada Limited also owns 25,000 (15.2%) of the presently outstanding 164,100 first preferred shares. The remaining 659,285 common shares and 139,100 first preferred shares, as well as the presently outstanding 1,841,862 convertible second preferred shares, are widely held by Canadian and foreign investors.

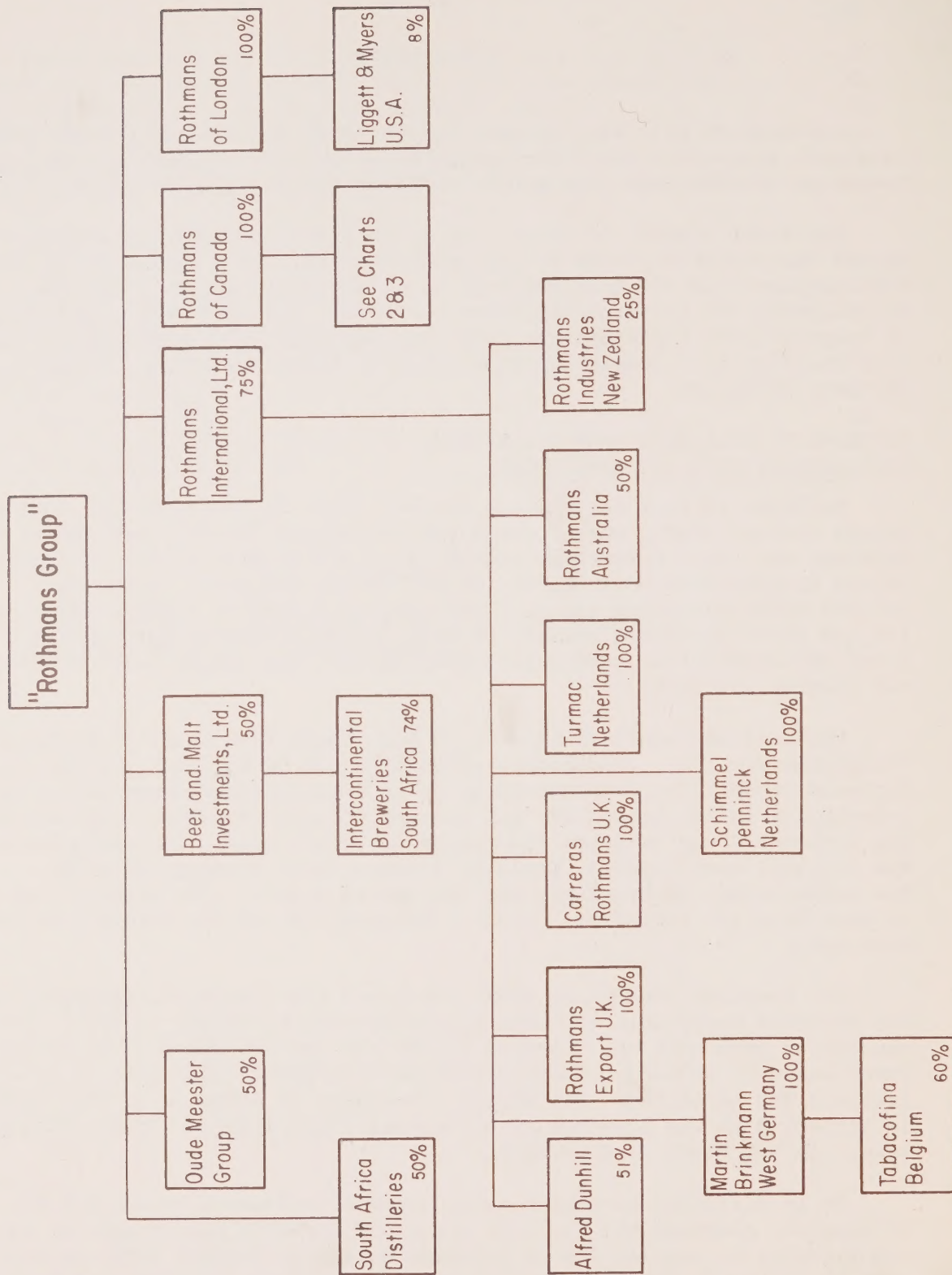
Rothmans of Canada Limited is in turn owned (see Chart 1) by the Rupert Foundation Soc. An., Luxembourg, commonly known in business circles as the Rothmans Group. The Rothmans Group is an international organization engaged principally in the production and sale of tobacco products, beer and wine. The Rothmans Group operates 102 plants in 26 countries, including Australia, New Zealand, South Africa, England, Ireland, West Germany, Belgium, The Netherlands, Switzerland, and the United States. Its products are sold in more than 180 countries. Chart 1 depicts some of the Rothmans Group holdings.

The Canadian subsidiary (RPM) purchased its cigarette trademarks from the Rothmans Group when it commenced operations in Canada in 1957. Initially management personnel was supplied to RPM but now the Group's day-to-day involvement is reduced to making available worldwide expertise in tobacco research and marketing. Its direct investment in Rothmans of Pall Mall Canada is reflected in the presence of an international director of the Rothmans Group, on the Board of directors.

It is difficult to detect other areas of influence or measure the extent of control, although the Rothmans Group did directly participate in the negotiations to acquire 11% of Canadian Breweries Limited (CBL) in 1968 and control of CBL in the spring of 1969 (see page 21). Rothmans of Pall Mall

Chart 1

The Rupert Group Empire

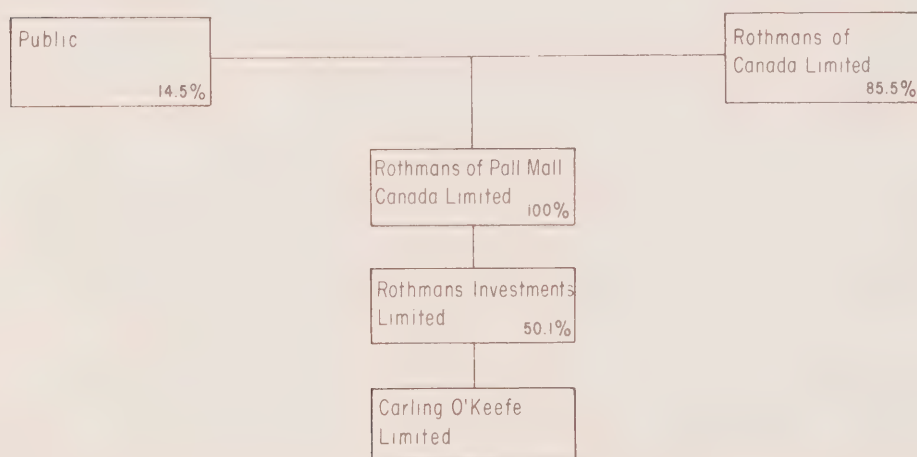


officials vehemently deny any day-to-day interaction with the Rothmans Group and also take issue with the generally perceived idea that major decisions affecting either the Canadian tobacco or brewing operations are scrutinized by the Group. Contrary to this denial there is the indication to be found in reports from observers of the tobacco industry, who state that in Liggett and Myers Inc., a huge U.S. consumer products conglomerate with only 8.5% of shares owned by the Rothmans Group, all major decisions are cleared with the Group. If this is true, then it probably applies to the Rothmans companies in Canada and to their subsidiaries. Corroborating evidence comes from an article on November 2, 1975 entitled "And the Beer Biz" in which the Toronto Star indicated that Carling O'Keefe's chairman of the board reports directly to the Rothmans Group in London. However, in discussions with the author, as well as with the Toronto Star, Rothmans' management in Canada have indicated that this report is erroneous. No retractions were printed, hence, the impression of foreign domination remains with the public.

Charts 2 and 3 outline the corporate relationships between Rothmans of Canada and its subsidiaries.

Chart 2

Rothmans of Canada and Subsidiaries



In the fall of 1974 Rothmans of Canada Limited and its affiliates exercised the conversion of 1,003,988 second preferred shares and 1,950,000 third preferred shares, as a result of which ROC increased its holdings of the common shares to the current level. The company intends to reduce its common share holdings to 50% at some future date. Chart 1 depicts the international philosophy of joint ownership with public investors in the countries in which the Group operates; e.g. 50% ownership of Rothmans Australia, 25% Rothmans Industries New Zealand, etc.

The conversion of the second and third convertible preferred shares came in 1975, when Price Waterhouse & Co., the auditors of Rothmans of Pall Mall Canada Limited, insisted that the company write down its investment in Carling O'Keefe Limited by a substantial amount (\$70-\$75 million). The

Chart 3

ROTHMANS OF PALL MALL CANADA LIMITED AND SUBSIDIARIES

Rothmans of Pall Mall-Canada Limited		
Carling O'Keefe Limited 50.1		
Tobacco	Wine & Spirits	Brewing & Beverages
— Alfred Dunhill of London, Limited 100	— Jordan Valley Wines Limited 92	— Canada 100
— Clarendon Imports Inc. 100	— Jordan Wines Alberta Ltd. 97	— The Bennett Brewing Company, Limited 100
— DSF Customer Services Limited 100	— Jordan Wines (B.C.) Limited 100	— Haig Beverages Limited 100
— John Perilly Limited 100	— Jordan Wines Limited 100	— Calgary Brewing Company Limited 100
— Martins of Piccadilly Canada Limited 100	— Dantforth Estates Division ¹ 100	— Canadian Breweries Ontario Limited 100
— Rothmans Canada Kings Limited 100	— Jordan Wines (Quebec) Ltd. 100	— The Carling Breweries Limited 100
— Rothmans Gold Leaf Tobacco Company Limited 100	— Ste. Michelle Wines Limited 100	— Carling O'Keefe Transport Limited 100
— Rothmans Investments Limited 100	— Castle Wines of Canada Limited 100	— Carlsberg Breweries of Canada Ltd. 100
— Talvis International Ltd. 100	— Ste. Michelle Wines of Saskatchewan Limited 100	— Doran's Beverage Company Limited 100
— Rock City Tobacco Company Limited 100	— The P.G. Thornley Company of Canada Limited 100	— Doran's Northern Ontario Breweries Limited 100
— House of Craven Limited 100	— Pacific Auto-Plas Industries Limited 50	— Dow Brewery Limited 100
— Filtramat of Canada Limited 100		— La Brasserie des Trois Couronnes 100
— Parkgate Estates Limited 100		— "Drei Kriemen Brauerei" 1308 ¹¹ Québec Limitée 100
— Peter Stuyvesant of Canada Limited 100		— Georges Labrecque Limitée 100
— Rembrandt Tobacco Corporation of Canada Limited 100		— La Brasserie O'Keefe Quebec Liée 100
— Rothmans Holdings Canada Limited 100		— O'Keefe Brewing Company Limited 100
		— The Performing Arts Corporation Limited 100
		— Tuborg Breweries of Canada Limited 100
		— United States 100
		— Carling National Breweries Inc. 100
		— Carling Breweries, Inc. 100
		— Carling Distributors, Inc. 100
		— Century Importers Inc. 100
		— Bahama Islands 100
		— Associated Bahamian Breweries Limited 100
		— England 100
		— Carbrew Limited 100
		— Republic of Ireland 100
		— Beamish & Crawford Limited 100
		— Carlsberg Breweries of Ireland Ltd. 100
		— Tuborg Breweries of Ireland Ltd. 100
		— No Share Capital Corporations
		— Carling O'Keefe Foundation
		— The Carling Community Arts Foundation
		— Dow Brewery Foundation
		— The O'Keefe Sports Foundation

NOTE: Figures indicate percentage of ownership

SOURCE: Rothmans of Pall Mall Canada Limited
as at March 31st, 1976.

conversion increased the capital stock account of common shares by \$59.1 million to \$75.2 million. At year-end, June 30th, 1975, this account was reduced by \$71.6 million to \$3.6 million reflecting the reduced value of the investment in Carling O'Keefe Limited. If the conversion has not been effected by Rothmans of Canada and its affiliated companies, the retained earnings account would have been reduced from \$30.3 million to minus \$41.3 million. Both common and preferred share dividends would have been suspended until a point in time that there were positive retained earnings; so dividends could be again declared. In reality, the conversion by the Group, protected both its dividends flow and the position of the minority shareholders.

DIRECTOR/MANAGEMENT: CROSS RELATIONSHIPS
WITHIN THE TWO COMPANIES

When Rothmans of Pall Mall was first rumored to have an interest in Canadian Breweries Limited (CBL) in 1968, the only link between the two companies was a common director, Mr. Charles Burns, Chairman of Burns Bros. and Denton Ltd., investment dealers. In financial circles, Mr. Burns was later regarded as highly instrumental in obtaining a block of CBL stock owned by the Argus Corporation for Rothmans in June of that year.

Mr. Burns resigned from both boards in 1969 when his investment firm terminated its fiscal agency relationship with Rothmans of Pall Mall on a point of principle concerning the treatment of minority shareholders in the proposed financing of the takeover of Canadian Breweries by Rothmans.

During the fiscal year April 30th, 1968, in addition to Mr. Burns, five other senior directors from Rothmans were elected to the Canadian Breweries board, replacing directors appointed by Argus. Following the Argus controlling policy, with only 11% of the common stock Rothmans was represented by 6 of 20 directors. Moreover, during fiscal 1968, Rothmans quickly introduced its own members into the management team at CBL.

By April 30th, 1969, a former Rothmans executive, Paul Erasmus, had become president and the Canadian Breweries board was reduced to 14 members, 7 of them also directors of Rothmans. Between 1969 and mid-1975, Rothmans maintained its policy of cross-directorship representation (Table 1). (The Appendix presents the names of those involved.)

In July of 1975, Rothmans decided to eliminate dual directorships in order to clarify lines of reporting and responsibility. Each major operating subsidiary would now be represented by its chairman on the Board of directors of its parent company. Hence, the interlocking directorships with Canadian Breweries Limited (now Carling O'Keefe) were reduced to one person, John C. Lockwood, chairman of the board.

Since Rothmans acquired control, there have been several changes in management personnel, strategy and structure at Carling O'Keefe. Between 1967 and 1970 officers grew from 8 in number to 17 as Rothmans attempted to define management responsibility and authority to correspond to its "modus operandi" in the tobacco sector. Between 1968 and 1975, there have been at

Table 1

CROSS-DIRECTORSHIP REPRESENTATION

<u>Fiscal</u>	<u>Total Carling O'Keefe Directors</u>	<u>Directors Common to Both Companies</u>
1969	14	7
1970	14	8
1971	14	8
1972	13	7
1973	14	7
1974	14	7
1975	12	1
1976	12	1

least 32 officers appointed at the senior management level, 10 other changes in responsibilities, and at least 15 senior management departures from Carling O'Keefe.

At present, two former Rothmans managers hold senior positions in Carling O'Keefe. These are Mr. B. Edwards, vice-president and Mr. J. Barnett, comptroller.

FINANCIAL PERFORMANCE

With the acquisition of Carling O'Keefe, Rothmans diversified from tobacco, its major product, into brewing and, through Carling, later obtained interests in the wine and oil and gas industries. Unfortunately, the new businesses have not yet proved to be good investments. Consolidated results over the past five years have been penalized by the poor performance of brewing operations. To give a more precise picture, the relevant figures for the 1970-77 period are set out in Table 2.

Table 2

ROTHMANS OF PALL MALL CANADA LIMITED
FINANCIAL HIGHLIGHTS FOR FISCAL YEARS 1970-1977

A. CONSOLIDATED RESULTS

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Revenue (\$MM)	238.1	336.4	359.0	381.6	400.2	468.0	526.1	\$593.8
Operating Margin (%)	12.7	12.6	11.6	9.5	8.3	12.4	12.7	10.4
Working Capital (\$MM)	52.7	92.3	77.1	67.2	61.5	86.8	72.2	75.7
Income Tax Rate (%)	50.5	51.4	49.0	40.3	58.2	49.7	46.9	43.1
Net for common (\$MM)	1.3	2.0	4.8	5.9	1.5	11.3	17.5	15.8
Common Shares O/S (MM)	1.6	1.6	1.6	1.6	1.6	4.6	4.6	4.6
Cash flow/share (\$)	8.56	11.4	12.9	18.4	12.78	6.78	8.47	8.78
Earnings/share (\$)	0.67	1.23	2.97	3.68	0.94	2.90	3.84	3.46
Dividends/share (\$)	0.75	--	--	--	0.50	0.50	0.50	0.52
Payout ratio (%)	89.02	--	--	--	61.0	17.8	13.0	15.0
Equity/share (\$)	14.39	14.98	17.55	22.52	23.11	17.89	20.80	23.74
Return on inv. capital (\$)	3.18	2.91	3.74	3.62	2.7	6.8	7.7	9.2
Return on equity (%)	5.66	16.34	22.91	18.59	3.1	12.9	22.0	17.6
Fully diluted E.P.S. (\$)	--	--	1.59	1.89	1.15	2.67	3.20	2.93

B. TOBACCO BUSINESS

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Net Sales (\$MM)	79.3	85.4	96.4	108.7	123.7	147.3	168.8	175.7
Operating Income	15.5	19.5	23.2	26.8	29.9	39.7	46.1	41.5
Operating Margin (%)	19.6	22.8	24.1	24.7	24.2	27.0	27.3	23.6
Net Profit (\$MM)	4.8	6.5	9.4	11.5	12.6	17.3	21.7	18.0
Working Capital (\$MM)	22.3	6.8	8.2	9.2	16.9	38.5	45.1	56.1
Capital Employed (\$MM)	139.0	139.1	142.6	149.6	150.5	114.1	123.2	132.8
Return on Capital (%)	3.5	4.7	6.6	7.7	8.4	15.2	17.6	14.7

NOTE: Fiscals 1970-1975 - June 30th year ends.
Fiscal 1976 - March 31st year ends.

C. BREWING AND DIVERSIFIED OPERATIONS

(Carling O'Keefe and Subsidiaries)

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Net Sales (\$MM)	260.4	251.0	256.9	264.0	274.7	317.0	357.3	418.1
Operating Income (\$)	25.4	22.5	22.1	23.3	7.4	14.7	16.6	20.2
Operating Margin (%)	9.8	8.9	8.6	8.8	2.7	7.9	4.6	4.8
Net Profit (\$MM)	11.3	7.6	8.2	6.1	(5.0)	(0.9)	(0.6)	1.3
Working Capital (\$MM)	45.7	85.5	68.9	58.0	50.3	48.3	27.1	19.6
Current Ratio (%)	2.2	3.2	2.2	1.9	1.9	1.8	1.4	1.2
Equity employed (\$MM)	172.6	167.6	163.0	168.5	162.3	159.3	151.7	154.8
Return on Equity (%)	6.7	4.5	5.2	3.6	n.a.	n.a.	n.a.	0.8

CHAPTER 2

ROTHMANS OF PALL MALL CANADA LIMITED

Rothmans of Pall Mall Canada Limited (RPM) is a company usually identified with its most visible product, Rothmans King Size cigarettes. Through subsidiaries, however, it is also involved in wineries, oil and gas, and breweries in Canada, the United States, and Ireland. The performance of these non-tobacco subsidiaries will be discussed in Chapter 3 on the main holding company, Carling O'Keefe. This chapter concentrates on Rothmans of Pall Mall Canada Limited and:

- (a) Its place in the Canadian tobacco industry;
- (b) its acquisition program since 1960; and
- (c) its performance as a corporate citizen.

ROTHMANS AND THE TOBACCO INDUSTRY

In recent years, Rothmans of Pall Mall Canada Limited has had a successful marketing and profitability record from tobacco operations. Growth has not been slowed by intense government intervention in the industry, and the company's market share has increased to over 28%, despite determined competition from others in the four large foreign-owned companies that dominate the cigarette market in Canada (see Table 3).

Up to 1974, much of the decline in market share of Imperial Tobacco came from increased competition by Rothmans and Benson and Hedges. In that year, Macdonald's was acquired by R.J. Reynolds Industries Inc., of Salem, North Carolina, who manufacture Winston's, America's second largest selling cigarette brand. Reynolds has added to the Macdonald's management team, redesigned packages, and announced the introduction of Canadian-blended Winston, Salem and Vantage cigarettes. While this resurgence of life at Macdonald's is causing some concern at the other tobacco companies, it is doubtful that Macdonald's market share will improve in the near term. Current marketing restrictions hamper efforts to revitalize dying brands and severely curtail the likelihood of immediate success for new brands.

Two small tobacco processors make up the remainder of the market, but they cannot compete with the majors because of lack of capital and/or capable management. Because of their insignificance their individual market shares are not known.

The industry as a whole is effectively regulated by government which, besides imposing heavy excise taxes, uses moral suasion and direct legislation in an attempt to control demand as well as marketing practices. The ways the companies operate under government restrictions and the various other considerations that affect marketing and pricing policies are discussed in the following sections.

Table 3

MARKET SHARE OF THE FOUR LEADING CIGARETTE

MANUFACTURERS, 1961-1976

	<u>1961</u>	<u>1966</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>
Imperial Tobacco Co. of Canada Ltd. (Imasco)	43.2%	42.5%	38.4%	37.3%	37.1%	37.9%	36.7%	37.7%
Rothmans of Pall Mall Canada Ltd.	15.8	21.9	24.8	25.6	26.9	27.5	28.0	22.8
Macdonald Tobacco Inc.	26.4	26.2	23.4	23.2	21.4	20.5	20.1	19.4
Benson & Hedges (Canada) Ltd.	4.6	9.4	13.4	13.9	14.6	14.1	14.8	14.7
Others	-	-	-	-	-	-	0.4	0.4

Source: Rothmans' Annual Reports, R.G. Shoniker & Associates Inc.

GOVERNMENT RESTRICTION

The effect of smoking on health has been a controversial subject for a great number of years. One of the focal points of the controversy has been the 1964 U.S. Surgeon-General's report that linked tobacco with cancer. While this report accentuated public concern and has resulted in a number of new anti-smoking programs in the United States, questions have been raised about the research methodology behind it. In Canada, the Federal Government nonetheless was prompted to require tobacco manufacturers to reduce expenditures on advertising and change its content. One important result was an updated Cigarette Advertising Code, adopted voluntarily by the major Canadian tobacco manufacturers in 1972 and revised in early 1976. The main clauses of this Code are as follows:

- eliminate all cigarette advertising on television and radio;
- equate advertising and promotion expenditures in other media with 1971 levels of about \$40 million, with a partial adjustment for inflation of costs annually;
- set up limits on the tar and nicotine content of cigarettes;
- print a warning from Health and Welfare Canada on all cigarette packages.

British Columbia has amended its law on cigarette advertising to compel advertisers to include the Health & Welfare warning on all billboards, display material and printed advertising. Acting on suggestions

by the Federal Government, the Canadian Tobacco Manufacturers' Council voluntarily agreed to follow this practice nationally in all print advertisements placed by its members. The industry has also begun to include the tar and nicotine content on cigarette packages and in advertising as additional health warnings. Between 1972 and 1975, the broadcasting ad ban had three significant effects on the Canadian cigarette market thus far:

1. Except for the new brands put out by Macdonald's after Reynolds' involvement in 1974, the number of new brand introductions were reduced from about seven to three annually. The new national brand introduction period has been lengthened from 3-6 months to 2-3 years. However, over the last 18 months many new brands have been introduced in the low tar and nicotine sector.
2. The public has switched from promotional brands (e.g. Sweet Caporal, Sportsman) to the traditional brands (e.g. Player's, Rothmans).
3. Advertising expenditures have been held to the 1972 level plus inflation.

However, as the main object of all tobacco advertising has been to increase brand shares rather than to expand the total market, it is doubtful that the broadcast ban will deter consumption. (This observation is backed up by experience in other countries. For example, in Italy sales have gained by more than 3% annually since an advertising ban in 1962, and in the Netherlands consumption has increased by 4% since a T.V. advertising ban in 1964.)

In Canada, the anti-smoking campaign by the government and the medical profession during the latter half of the sixties cut consumption growth from 6% annually between 1961 and 1966 to 2.9% annually in the 1966-1972 period. Consumption then increased moderately at 3% in 1973 and 4% in 1974. (See Table 4 for detailed figures since 1966). While cigarette sales growth slowed to 1% in 1975 as higher taxes and price increases curbed demand, a multitude of new brands introduced into the low tar sector resulted in a 5.3% increase in 1976.

Thus, the removal of broadcast advertising in Canada has probably had the effect, not so much of reducing demands, as reducing the tendency to switch brands. Cigarette consumers are in any case brand loyal; for an average smoker, brand loyalty lasts at most about five years. Heaviest smokers tend to be in the 25 to 40 year-old age group.

With the removal of broadcasting as a viable medium for brand promotion and a ceiling on media expenditures, the tobacco industry has realigned much of its promotion to sports and cultural events which, marketing research indicates, fit the consumer profile of a particular brand and the lifestyle of a typical consumer. In addition, cigarette packages have been revamped, old brands reintroduced, and package color preferences and smoker tastes carefully researched. The total effect has almost been to eclipse the warning that "Danger to health increases with the amount smoked--avoid inhaling". In some advertisements, mood is stressed. Cigarette manufacturers are trying to sell satisfaction, and therefore their advertising links their products to the good life.

Table 4

CIGARETTE CONSUMPTION IN CANADA

1966-1976

	<u>Total Cigarettes Consumed</u>	<u>Per Capita Consumption Over 15 Years Old</u>	<u>Population Over 15 Years Old</u>
	(MM)		(MM)
1966	46,276	3,453	13.4
1967	47,340	3,455	13.7
1968	46,683	3,335	14.0
1969	47,487	3,321	14.3
1970	50,170	3,435	14.6
1971	52,072	3,471	15.0
1972	53,300	3,509	15.2
1973	54,900	3,545	15.5
1974	57,100	3,614	15.8
1975	57,700	3,540	16.3
1976	60,744	3,637	16.7
Annual Growth Rates			
1966-1971	2.9%	0.1%	2.9%
1971-1972	2.3	1.1	1.3
1972-1973	3.0	1.0	1.9
1973-1974	4.0	1.9	1.9
1974-1975	1.1	-2.1	3.2
1975-1976	5.3	2.7	2.5

Source: Imperial Tobacco Ltd.
Statistics Canada 91.514

Unfortunately, market share figures for cigarette brands are not publicly available. Based on discussions with industry executives, our best estimate of the position of the leading brands is as shown in Table 5.

While these top five brand names account for over 60% of the market, a multitude of popular brands comprise the remainder. Perhaps the most interesting fact of the brand list is the dependence of Rothmans and Macdonald's on their leading brands, which account for nearly one-half of their respective sales.

Table 5

MARKET SHARE OF TOP-SELLING

BRANDS OF CIGARETTES

<u>BRAND</u>	<u>COMPANY</u>	<u>MARKET SHARE*</u>
Export ("A" & Plain)	Macdonald	17.4%
Rothmans	Rothmans	12.5%
du Maurier (King & Reg.)	Imasco	11.2%
Players (Filter & Plain)	Imasco	11.0%
Craven (King, "A", Menthol)	Rothmans	<u>8.4%</u>

* As of March 31, 1977

MARKETING PRACTICES

All companies market their cigarettes at a common price; hence, pricing is not viewed as a major marketing variable.

As has been shown in industry studies, gradual price increments have very little effect on demand. In point of fact, until recently the industry gave no heed to possible consumer resistance to price increases. Between the spring of 1974 and the fall of 1975, for example, four price increases (one tax, three industry) amounting to 17% have been imposed and, although manufacturers have expressed some concern over the possibility of consumer resistance, "roll-your-own" cigarette smokers are still declining in number.

On the other hand, manufacturers have tried to market a premium price cigarette from time to time, but with very little success. It appears that the customer is unwilling to trade up and regards cigarettes as a convenience item or in some cases as a staple.

In May of 1974, Imasco introduced a "discount" brand, Turret, to compete in Quebec with the coupon brand, Mark Ten of Benson & Hedges. Turret has achieved modest success. Imasco extended this brand's penetration nationally in early 1976. It is doubtful that the competition will follow suit, as the discount sector accounts for less than 1% of the total market.

With its inelastic demand, the industry will in all likelihood continue to experience increased taxes by various governments. At present, the federal government collects 32.1¢ per pack of king-size 25s sold, and provincial government sales taxes range from 8¢ to 41¢ for a pack of 25s.

These combined levies account for about 55% of the retail price of a pack of cigarettes. The complete breakdown of price is as follows:

As at March 31st, 1977

Excise and sales taxes	55.5
Raw material & manufacturing	
Expenses	25.5
Marketing & distribution expenses	7.3
Administration & other expenses	3.7
Pre-tax earnings	<u>8.0</u>
	100.0%

As can be seen, production costs have very little bearing on price. Tobacco accounts for about 45% of the cost of production and, because tobacco substitutes have found little consumer acceptance, this percentage is unlikely to change. Tobacco costs have been rising (Chart 4) and are not likely to be reduced by pressure on source of supply, because of the strength of a tobacco marketing board in Ontario, where most Canadian tobacco is grown. This body, properly known as the Ontario Flue-Cured Tobacco Growers' Marketing Board, introduced an auction system for leaf tobacco in 1957. By 1971 this system had advanced to the state that the tobacco companies agreed to guarantee a minimum average price per pound for a year's crop, based on a specified harvest size. In 1976, the guarantee was altered to reward and encourage growers of higher quality tobacco with a minimum price per grade of tobacco. Thus, individual farmers are ensured a foreseeable and realizable income.

The auctions of the 1975 Ontario flue-cured leaf tobacco closed in the spring of 1976 with sales totalling 210 million pounds compared to 238 million pounds the previous year. The average price paid during the auction was 81 cents per pound. However, the Canadian tobacco manufacturers had guaranteed an overall auction price of 94 cents per pound and the deficiency of 13 cents a pound (totalling \$26.7 million) was contributed on a pro-ratio basis by the four major companies.

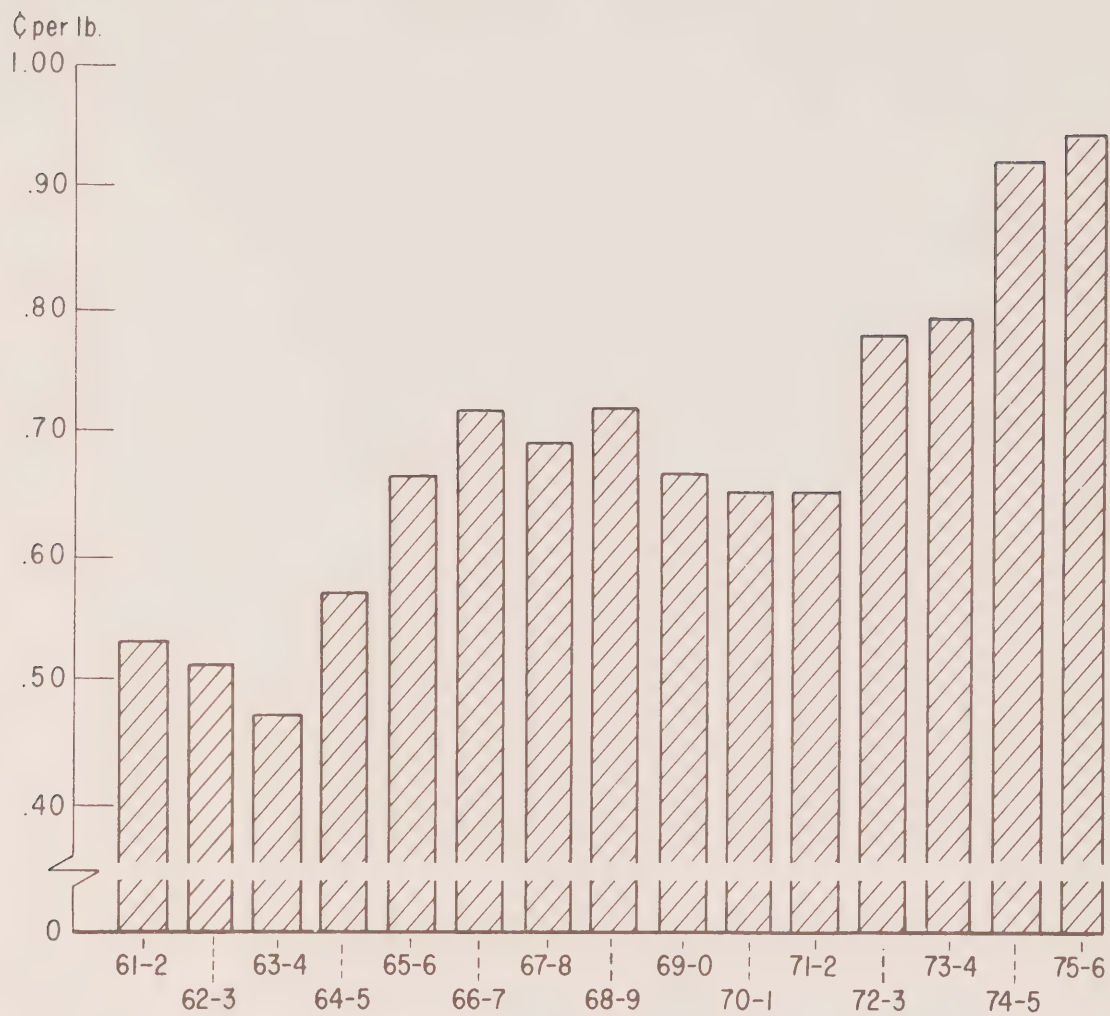
As for distribution, the three-tier system still exists, i.e., manufacturer, wholesaler, retailer. However, some cigarette manufacturers have been actively involved in the retail sector, most notably Imasco (vending (sold in 1977) and retail stores) and Benson & Hedges (specialty chain which was sold in 1977), and it was estimated that these two companies account for about 12% of the retail tobacco business. The reason the wholesaler survives is that he supplies the independents, who sell a great proportion of cigarettes, as the following figures show:

SHARE OF CIGARETTE SALES BY OUTLETS:

Vending	10.8%
Convenience stores	9.4%
Chain Stores	21.0%
Independents	<u>58.8%</u>
	100.00%

Chart 4

Tobacco Leaf Cost



Source: R.G. Shoniker & Associates Inc.

ROTHMANS OF PALL MALL CANADA'S

ACQUISITION PROGRAM

Between 1960 and 1970, RPM acquired four other companies, three of which were in the tobacco industry, i.e., Rock City Tobacco Co., (1960) Limited, over the period 1960-1963; Larus & Brother Company in 1968; and Alfred Dunhill London Limited and Canadian Breweries Limited, which in turn acquired interest in wine, soft drinks, and oil and gas, changing its name to Carling O'Keefe Limited in 1973. Not all of these transactions were at arm's length; in particular, the Rock City acquisition was inter-corporate. These transactions are described one by one in the following sections.

ACQUISITION OF ROCK CITY

In 1958, the Rothmans Group acquired a voting control of Carreras Limited of England, which held approximately 70% of the outstanding voting shares of Rock City Tobacco Company (1936) Limited of Quebec City. The remaining 30% was held by private investors in Canada. According to an estimate by Business Week*, the Rothmans Group paid less than \$4.5 million to gain control of Carreras, which had trade marks for Craven "A", Black Cat and Piccadilly cigarettes in Great Britain and certain other countries, including Canada.

During the period from March 1959 to December 1960, Rock City continued to operate as a subsidiary of Carreras. With the 1958 acquisition of Rock City by its affiliate company (Carreras), earlier plans for a new manufacturing plant for Rothmans of Pall Mall Canada Limited were dropped. Rock City then, through internally generated funds, commenced a \$2 million re-equipment program for its own facilities. Between 1958 and 1960, Carreras made an offer for the remaining shares of Rock City on the condition that all of the shareholders accepted. The first offer aborted because of one holdout and the second offer was successful for a total consideration of \$2.5 million. By December 1960, Rock City was a wholly-owned subsidiary of Carreras.

The total investment in Carreras and Rock City by the Rothmans Group appears to be a maximum of \$9 million (\$4 million purchase of Carreras, \$2 million investment in plant and equipment, \$2.5 million for remaining 30% of Rock City). This investment was later "shared" with the Canadian public through a series of financial transactions described below.

In December of 1960, Carreras sold the manufacturing facilities of Rock City (1936) Limited to RPM for book value of \$4.4 million plus inventory of \$0.8 million, a total consideration of \$5.2 million. Then Carreras formed a company called Rock City Tobacco Company (1960) Limited to own and market the old Rock City brands. It purchased the trademarks

* - Business Week, September 28, 1974, "South Africa's Mystery Man: Anton E. Rupert", Page 84.

CHRONOLOGICAL SEQUENCE OF

ROTHMAN'S EARLY CANADIAN

CORPORATE HISTORY

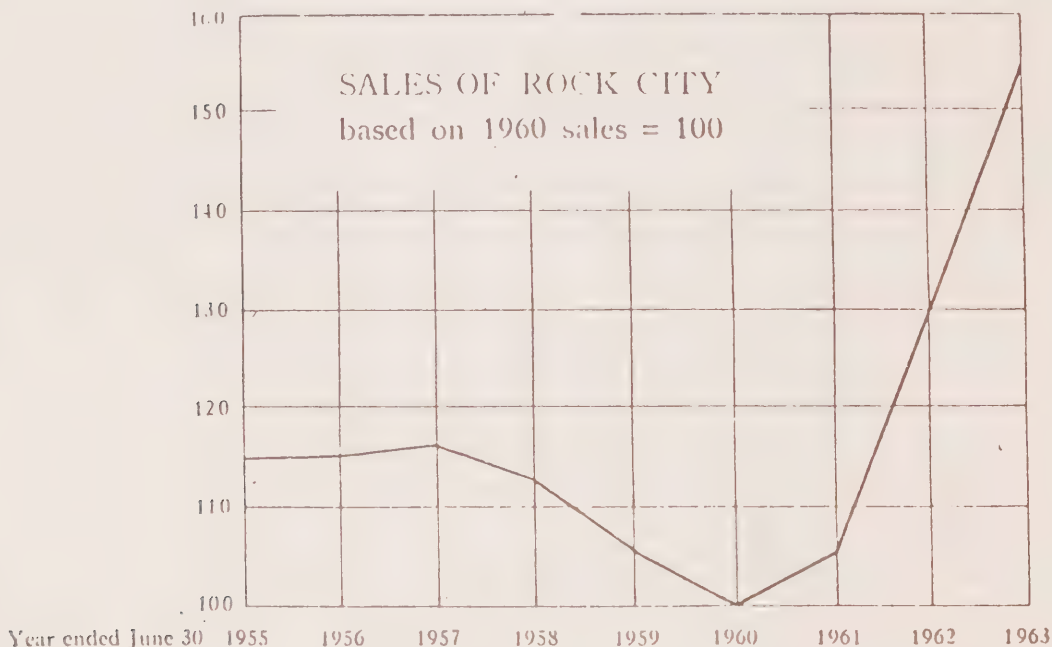
Date

May 8, 1956	Rothmans of Pall Mall Canada Limited incorporated to manufacture and sell cigarettes in Canada.
1958	Rothmans Group attains 70% interest in Rock City Tobacco Company (1936) Limited of Quebec City through international acquisition of Carreras Limited of London, England.
1959	Plans for a new manufacturing plant for Rothmans of Pall Mall cancelled.
Dec. 1960	Carreras Limited acquires remainder of Rock City Tobacco Company (1936) Limited from Canadian minority shareholders for \$2.5 million. Carreras Limited sells Rock City Tobacco Co. (1936) Limited's manufacturing facilities to Rothmans of Pall Mall Limited for \$5.2 million. Carreras then forms Rock City (1960) Limited to own and market former Rock City 1936's brands. Rock City (1960) was then sold to newly formed Rothmans of Canada Limited for \$7.3 million.
March 1961	Rothmans of Pall Mall Canada Limited goes public with a \$6.5 million issue.
October 1963	Rothmans of Pall Mall Canada Limited acquires Rock City (1960) Limited from Rothmans of Canada Limited for an approximate consideration of \$12.3 million.

and certain inventories of Rock City (1936). Rothmans of Canada Limited (ROC) was concurrently formed, and it acquired Rock City (1960) from Carreras for \$7.3 million net.

Rock City (1960) actively commenced business on January of 1961. As Rock City (1936) had been slow to enter the filter market in the 1950's, its brands had been declining and it had suffered substantially from the increased competition from Rothmans and Tobacofina. Thus in 1961, new brands were introduced and the old brands of Rock City given a face lift. The following chart which appeared in a Rothmans Information Circular in 1963 shows the effect of these changes.

Chart 5



A manufacturing agreement with Rock City (1960) guaranteed Rothmans of Pall Mall Canada Limited its costs plus a profit on all products produced. Following this series of transactions, RPM earned its first profit and was able to offer its common shares to the Canadian public.

In March of 1961, the Canadian public was offered 650,000 common shares of Rothmans of Pall Mall Canada Limited at \$10 a share; the offer was fully subscribed. The \$6.5 million raised was disbursed as follows: \$4.5 million to repay the loan from ROC that had been used to buy the assets of Rock City, and \$2 million to reduce a bank loan.

In October of 1963, Rothmans of Pall Mall Canada Limited acquired all outstanding capital of Rock City (1960) Limited from Rothmans of Canada for an approximate consideration of \$12.3 million. This purchase was satisfied by the issuance of the following securities by the company: 5% unsecured notes, \$5.1 million, payable to ROC by

Rothmans of Pall Mall; 5% unsecured notes, \$2.3 million owing by Rock City (1960) to ROC payable by Rothmans of Pall Mall; \$1.8 million in first deferred shares which represented the net amount of the tax deductions arising from the losses in Rock City (1960), (the conditions on the deferred shares made it possible for ROC to receive this amount only after Rothmans of Pall Mall Canada had earned \$780,000 - 6% of its capital share of \$13 million - in each year), and \$3 million in second convertible shares; convertible out of earnings in excess of 6% per annum with a 12 year time limit.

Through a well-prepared information circular, the public shareholders were presented with full disclosure by the Rothman Group. The Group also indicated that it would vote its 50% in favour of the transaction only if the balance of the shareholders were in agreement.

Combining the asset purchase of 1960 and the share purchase of 1963, RPM paid ROC \$17.5 million for a business that had cost the Rothmans Group at most \$9 million. At this time, Rock City was marginally profitable at best, with earnings of \$0.7 million for the year ending June 30, 1963. Even a generous market capitalization at 10 times earnings would have given maximum value of \$7 million for the company.

It appears that the Rothmans of Pall Mall management placed a rather high value on the potential of the trademarks of Rock City (1960). Over the last 13 years, in particular the Craven family of brands has been an outstanding success for the company.

At first glance, the casualties of the Rock City transactions were the minority shareholders of Rothmans of Pall Mall who were forced to forego dividend income until 1968, when the covenants of the preferred stock issue to ROC were satisfied. However, between 1963 and 1965, common share prices went from \$7 to \$27, and the minority shareholders did enjoy substantial capital appreciation. Certainly, because of Rock City, RPM was able to improve its sales and profit performance in the cigarette business, as Table 6 shows.

One reason was that the Rock City acquisition reduced the company's vulnerability as a one-brand operation, namely Rothmans, with the addition of Craven "A", Number 7, Black Cat, and other brands. Before Rock City, the Rothmans brand probably accounted for over 90% of sales versus the estimated present 47%. Another reason for improvement was that the addition of Rock City afforded the company economies of scale in purchasing, production and marketing which in turn aided the overall profit performance.

The merger of the two companies intensified competition within the industry at the promotional and distributional level. Although price cutting did occur, "generous terms" to wholesalers became widespread. A promotional war reached a peak with the coupon contests of 1970. After that, at the suggestion of the federal government, the industry stopped such marketing ploys. When broadcast advertising came to an end in January 1972, competition became more restrained and subtle.

Table 6

ROTHMANS OF PALL MALL CANADA LIMITED

SALES AND PROFIT PERFORMANCE, 1962-67

<u>Fiscal Year</u>	<u>Sales</u> (\$MM)	<u>Earnings</u> (\$MM)
1962	88.2	(2.5)
1963	108.4	0.8
1964*	115.1	1.0
1965	130.0	2.5
1966	142.7	3.2
1967	161.9	3.8

* - Rock City consolidated from 1964 onwards.

Assessing the effect of Rothmans' takeover on the former minority shareholders of Rock City, it would appear that the \$2.5 million purchase of the 30% minority interest of Rock City (1936) Limited was favourably received. Indications are that the minority shareholders had no interest in expanding or re-equipping Rock City, and therefore it was Rothmans' financial resources (plus eventually those of the Canadian public) that allowed Rock City to expand and generate new employment. No negative effects of the takeover have been voiced by the employees, and the labor relations record has been favorable.

Acquisition of Larus & Brother
Company by ROC

In October, 1968, Rothmans of Canada (ROC) purchased Larus through a wholly-owned subsidiary, Rothmans Holdings Limited (RHL) for a total consideration of \$6.5 million. RHL financed the purchase by borrowing \$3.5 million from ROC and issuing \$3 million in equity to ROC. Larus and Brother was a small family-owned tobacco operation in Virginia and was to be a vehicle for a test of the American market by Rothmans.

On November 21, 1968, Rothmans of Pall Mall Canada Limited bought 50% of the equity of RHL from ROC at cost, \$1.5 million, with funds generated from a \$20 million first preferred issue of January, 1969. The test market failed and these shares were subsequently sold back to ROC sometime around 1970 at cost.

ACQUISITION OF ALFRED DUNHILL
OF LONDON LIMITED

In July of 1970, for a total consideration of \$220,000, Rothmans of Pall Mall purchased Alfred Dunhill of London Limited, a Canadian-owned company from a non-Rothman - affiliated individual owner. This owner was producing and marketing the Dunhill line in Canada under an arrangement with Alfred Dunhill Limited, a Rothman Group company. Apparently the results did not meet the Rothmans Group's satisfaction and therefore it was decided to bring the Dunhill brand rights directly under the Group's wing through the purchase by Rothmans of Pall Mall Canada Limited.

Sales at the time of acquisition were reported to be about \$2 million. The RPM annual report for fiscal year 1976 states the Dunhill division's annual volume at \$4.4 million or more than 100% above the 1970 level.

The Acquisition of Canadian
Breweries Ltd. (Carling O'Keefe)

On June 6, 1968, Rothmans of Pall Mall Canada acquired 2,400,000 common shares of Canadian Breweries Limited (CBL) from the Argus Corporation for a total consideration of \$28.8 million, or \$12 a share, an approximate 50% premium on the stock market price. These shares represented 11% of the outstanding common shares of CBL. The acquisition was made through Rothmans Investments Limited (RIL), which was incorporated for this purpose. At that time Rothmans of Pall Mall Canada and Rothmans of Canada (ROC) each owned 50% of RIL.

In January of 1969, Rothmans of Pall Mall issued 200,000 first preferred shares for a total net consideration of \$19,250,000 and then applied \$12.8 million of that sum to acquire ROC's 50% interest in RIL. (ROC did purchase \$2.5 million of the first preferred issue.) Another \$4 million from the first preferred issue was invested in RIL to retire bank loans and other advances from ROC. Simply, the series of financial transactions for the purchase of Canadian Breweries looked as follows:

<u>Equity</u>	<u>(\$MM)</u>
Rothmans of Canada Investment in RIL	12.8
Rothmans of Pall Mall equity investment in RIL	12.0
Bank loan & advances from Rothmans of Canada	<u>4.0</u>
Total RIL investment equals acquisition price	<u>28.8</u>
Rothmans of Pall Mall purchases, ROC's interest in RIL from 1st preferred issue	12.8
Bank loan & ROC advances to RIL are retired from funds of 1st preferred issue	<u>4.0</u>
Investment in RIL passed to RPM	<u>\$16.8</u>

Between June of 1968 and the January 1969 first preferred share issue, another event took place that met with a great diversity of opinion. In August of 1968, Rothmans of Pall Mall Canada and Canadian Breweries Limited announced a proposed merger. Through a complicated cash and stock exchange, RPM would acquire control of Canadian Breweries, with the latter then being the operating entity for both beer and tobacco operations and RPM remaining a holding company. The proposed deal ran into a great deal of criticism in the press because:

- (a) the proposed purchase price of CBL shares equalled \$10.50 versus the \$12 a share paid to Argus;
- (b) strictly cash transactions in the deal would reduce Rothmans' purchase price of the Argus block of CBL stock from \$28.8 million to \$3.2 million;
- (c) many minority investors saw it as a raid on the cash of another corporation, as CBL was cash rich and Rothmans a mere pauper in comparison.*

Due to the lack of support in the investment community* the merger was postponed, and Rothmans was forced to find an alternative form of financing. Hence, the already discussed first preferred issue was designed. In hindsight, this transaction would have been of major benefit to the CBL holder as tobacco earnings would have been a buffer against the subsequent decline in beer earnings.

In May of 1969, Philip Morris & Company of New York offered to purchase up to 50% of Canadian Breweries Ltd. from Canadian shareholders for \$12 a share. Rothmans announced that it was considering fighting the offer, whereupon minority shareholders threatened a law suit if the company did not accept the Philip Morris offer. They pointed out that if it were accepted, Rothmans could reduce bank loans and redeem its first preferred issue, thus increase earnings per share by 55¢ annually. As the Financial Post indicated, "minority shareholders were increasingly disillusioned over Rothmans involvement in Canadian Breweries, and future prospects".* In addition, some investors were disturbed over the lack of a Rothmans common share dividend because of the CBL investment.

The takeover fight began in earnest in the summer, with Rothmans of Pall Mall indirectly paying as high as \$15 for shares. Through RHL, however, the average purchase price per share was \$13. RHL bought 8,373,200 shares for \$108.9 million, which Rothmans of Pall Mall financed partly by issue of a second and third convertible preferred issue. The transaction looked as follows:

* - The Financial Post, August 31, 1968, CBL - Rothmans Merger Spurs Mixed Shareholders Reactions, pages 17 & 30. See also The Financial Post, June 14, 1969, Rothmans Canadian Breweries; Happily Ever After, page 17, and The Financial Post, May 24, 1969, Arguments Pro & Con for Rothmans on U.S. Bid, page 3.

	<u>(\$MM)</u>
Rothmans of Pall Mall convertible preferred issues	
- Public participation	39.0 (1)
- Rothmans of Canada participation	<u>57.0</u> (2)
	96.0 (3)
Less Issue expenses	<u>1.8</u> (4)
	94.2 (5)
Bank Loan to Rothmans of Pall Mall	5.0 (6)
Special CBL dividend (on RIL's CBL holdings)	2.4 (7)
Repayment of loan by RHL	0.7 (8)
Demand loan by Rothmans of Canada	<u>6.6</u> (9)
	108.9 (10)

At first glance, it would appear that ROC's \$108.9 million investment in Canadian Breweries' shares was reduced to the convertible preferred issue of \$57 million (line 2) and the demand loan of \$6.6 million (line 9).

A special \$1 a share dividend (line 7) was soon declared by Canadian Breweries specifically to help RPM pay for the takeover, presumably the demand loan of ROC was paid back immediately and the bank borrowings of RPM reduced.

Rothmans of Canada and its affiliates participated to the extent of \$57 million worth of 2nd and 3rd convertible preferred shares of RPM, and renewed their intention to reduce their equity ownership to 50% of RPM at some time in the future.

Post-Acquisition Experience

Rothmans of Pall Mall's post-acquisition experience with Canadian Breweries Limited can best be examined by looking at four distinct areas: financial results to date, the position of the minority shareholders, the company's treatment of employees and the relationship of the brewery to the rest of the industry.

1. Financial Results. To the minority shareholders of Rothmans of Pall Mall Canada and Canadian Breweries Limited, renamed Carling O'Keefe Limited in 1973, the financial performance of RPM since the acquisition has been very poor. In spite of the infusion of new management and money, market share has been lost and beer volume and profitability have declined seriously. RPM's handling of its brewing operations, especially those in the United States, has come under severe

criticism from the financial community and minority shareholders of both entities.* Table 7 shows the operating highlights of the U.S. brewing subsidiary.

Table 7

PERFORMANCE OF U.S. BREWING OPERATIONS, 1970-77

	<u>(Fiscal Years Ended June 30, 1970-1975)</u>					<u>March 31</u> <u>1976 - 1977</u>		
	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Sales (MM barrels)	5.4	4.5	4.1	3.8	3.6	3.4	3.7	4.6
Sales (\$MM)	206.4	167.2	150.9	143.9	135.6	146.0	171.2	225.0
Net Earnings (\$MM)	2.8	0.6	(0.8)	(4.6)	(6.0)	(9.4)	(12.9)	0.6
Earnings Per Barrel (\$)	0.52	0.14	(0.19)	(1.20)	(1.68)	(2.76)	(3.50)	0.12

From the time that Rothmans acquired control, the decline in profitability in this division has been about \$32 million (fiscal 1977's results show a dramatic improvement due to an acquisition as well as a strike at the leading U.S. brewer).

In the U.S. beer market, Rothmans of Pall Mall Canada finds its brewing subsidiary, Carling National, operating in a highly competitive environment where a major rationalization of brewers is occurring. Through larger, more efficient modern brewing plants, price competition, aggressive marketing and large financial resources, the major national brewers (Anheuser Busch, Jos. Schlitz, Miller, Pabst) are gaining beer sales, market share and profitability at the expense of the smaller brewers. In effect, the U.S. brewing industry is undergoing the period of consolidation experienced in Canada in the 1950's.

Rothmans' management has attempted to reverse the fortunes of Carling by consolidating brewing operations into fewer plants to gain some production efficiencies launching new brands into the premium-price beer sector and streamlining marketing and administrative operations. However, these efforts have not met with much success.

* - The Globe & Mail - Report on Business, October 25, 1972; November 24, 1972; March 23, 1973, July 20, 1973; November 2, 1973; The Financial Post, November 4, 1972; December 9, 1972; September 20, 1975; The Toronto Star; November 15, 1975.

Since the end of fiscal 1973, both the financial and the brewing communities have therefore been anticipating the sale or termination of Rothmans of Pall Mall Canada's brewing interests in the United States. Shareholders at the annual meeting have openly chastised management for failing to face the fact that U.S. brewing problems are not solvable.

The \$9.4 million loss for fiscal 1975 brought new hopes to some dissident shareholders, who believed that a termination decision would be forced by the Rothmans Group. This hope was reinforced by the announcement that Rothmans of Pall Mall Canada was going to write down its investment in Carling O'Keefe by \$71.6 million and eliminate cross-directorships. The announcement in early September that Carling O'Keefe intended to acquire another medium-sized U.S. brewer, the National Brewing Company, was met with stunned disbelief in the financial community.*

By November, National Brewing had been acquired for a total consideration of \$25.5 million (\$16.5 million in cash and \$9 million payable over seven years if certain profitability requirements were met). Management then announced that (a) with the merger a higher sales volume could be expected which, through a further rationalization of production facilities, would reduce unit costs and hence increase potential profits, and (b) National Brewing brought to Carling O'Keefe additional brands of some merit in the premium-price sector. However, the investment community reasoned that the decision came from the Rothmans Group, who wanted a meaningful representation in the United States at any cost. It should be noted that both the RPM and CBL executives strongly disagree with the previous statement and insist that the decision was made independently.

A close examination of the transaction shows that the cost of the acquisition was approximately equal to one year's marketing budget. For this price, Carling captured about 2 million barrels of beer sales, two breweries and a well-respected management team headed by an individual whose family had been on the American beer scene for more than 100 years. It is beyond the scope of this report to forecast the possible success or failure of this move; however, it does appear to be a long shot at a successful turnaround.

The alternatives were to sell whole or parts of the U.S. brewing subsidiary or shut it down entirely. Either tactic would have resulted in a material write down of the asset value on the balance sheets of both Carling O'Keefe (estimated \$30 - \$40 million) and Rothmans of Pall Mall (estimated \$15 - \$20 million). Once again, it is beyond the scope of the report to speculate on the possible ramifications of the implementation of either of these strategies.

While the U.S. brewing operations floundered, the Canadian beer division had its problems as well (Table 8).

* - The Toronto Star, November 15, 1975, page 7.

Table 8

PERFORMANCE OF CANADIAN BREWING OPERATIONS, 1970-77

(Fiscal Years Ended June 30, 1970-1975

March 31, 1976 & 1977)

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Sales (MM barrels)	4.2	4.5	4.5	4.3	4.3	4.3	4.3	4.2
Sales (\$MM)	202.3	219.9	236.4	233.2	241.1	272.5	287.2	301.3
Net Earnings (\$MM)	6.3	6.5	7.1	6.0	1.5	4.6	6.2	2.0
Earnings Per Barrel (\$)	1.51	1.45	1.56	1.37	0.36	1.07	1.43	0.48

While the brewing industry as a whole has shown annual unit gains of 5% since 1970, Carling O'Keefe's volume performance has been stagnant in spite of a number of new brand introductions. Higher operating costs and a falling utilization of capacity rate contributed to the profit problems.

Rothmans of Pall Mall has probably met with a great deal of difficulty in adjusting to ways of marketing in the extensively controlled brewing industry. One great success was the introduction of the Heidelberg brand of beer in a keg-shaped bottle. However, in 1973, the unique bottle was banned in all markets by the liquor boards who stated that "handling and storage problems" forced the decision. Financial Analysts have for a long time questioned the credibility of this explanation and suggest that competitive forces were lobbying overtime.

While performance has been poor, Carling O'Keefe's financial position has grown even weaker due to the unfavourable profit results of the last seven years. The balance sheet in Table 9 presents the company's weakened position.

2. Position of Minority Shareholders. Poor operating performance has had an obvious effect on the valuation of the common shares of both companies in the stock market. As discussed later, market performance has been anything but orderly.

The acquisition severely strained Rothmans of Pall Mall's financial resources and position to the extent that the quarterly common share dividend of 25¢ was suspended in June of 1970 and not resumed until December 1973. Moreover, the poor operating results and weakening financial position resulted in the suspension of Carling O'Keefe's common shareholders' dividends

Table 9

CAPITAL STRUCTURE OF CARLING O'KEEFE LIMITED

1969 vs 1977

	Year End Position as at	
	<u>April 30, 1969</u> (000,000)	<u>March 31, 1977</u>
Cash & S.I. Notes	\$ 49.6	\$ 1.9
Less Bank Loans & Notes	--	37.5
Other Current Assets	57.7	110.2
Less Other Current Liabilities	<u>31.8</u>	<u>55.0</u>
Working Capital	75.5	19.6
Property, Plant, Equipment - Net	99.9	144.9
Investments & Other Assets	81.0	20.5
Goodwill	--	16.7
Less Long Term Debt	49.3	25.7
Less Deferred Inc. Taxes	11.3	19.6
Less Minority Interest	<u>--</u>	<u>1.6</u>
Capital Employed	<u>\$195.4</u>	<u>\$154.8</u>
Book Value Per Share	<u>\$ 6.90</u>	<u>\$ 5.13</u>

Source: Annual Report Canadian Breweries Limited, 1969.
Annual Report Carling O'Keefe Limited, 1977.

of 40¢ per annum in November 1972. At a very vocal annual company meeting that year, many minority shareholders voiced their displeasure at the dividend cut and pointed out that as small shareholders (the stock tended to be classified as a "widows and orphans" vehicle due to its dividend) they could not tolerate this move as easily as the major shareholder.

3. Treatment of Employees. As the fortunes of Carling O'Keefe dissipated, the number of employees was reduced, in spite of the post-Rothmans involvement and the acquisition program. The 1967 annual report stated that the company employed 6,200 people in Canada and the United States. By June 30, 1974, this number had been reduced to 5,200. The 1975 annual report did not reveal employee numbers; however, the fact that pension costs rose only 5.9% in fiscal 1975 over 1974, with administrative and general expenses declining to 10.5% over the same period, suggested that a further thinning of the ranks occurred. With the acquisition of National Brewing, the number of employees temporarily increased to 5,800 by the end of its fiscal year, March 31, 1976.

Carling O'Keefe relationships with its unions have probably been better under Rothmans' control than under the previous regime. Part of this improvement stems from a marketing program of the company to win over union people to Carling beer brands, in the belief that the blue-collar worker is the dominant beer drinker. With this marketing program came the removal of time clocks, more management and employee involvement, and some generous new settlements and benefits. However, it appears that the love affair between management and union has cooled considerably in the past 18 months as labour's demands have grown more onerous.

4. Relationship within the Industry. After Rothmans' takeover, Carling O'Keefe removed itself from membership in industry-sponsored associations, including the Association of Canadian Brewers, because Rothmans felt that other members were discovering too rapidly what Carling O'Keefe was going to do next. Moreover, it was reasoned that cancellation of membership would save a few hundred thousand dollars in fees.

The attempt to revitalize Carling O'Keefe probably has increased competition in the industry by forcing the other brewing companies to do better planning, research and advertising. However, it is difficult to instill competition into an industry where the "four P's" of marketing--price, place, promotion, and product--are so rigidly controlled by the provincial and federal authorities.

Stock Market Reaction to the Acquisition of CBL

Over the two years prior to the acquisition, the shares of both Rothmans and Canadian Breweries reflected their separate outlooks, and both moved ahead though with a great deal of volatility. (See Charts 6 and 7 for monthly price movements and volumes of the respective common shares from 1966 to mid-1975). Beginning with RPM's purchase of 11% of the brewery shares in June 1968, both stocks became more heavily traded. In anticipation of the actual takeover, the trading volume of Canadian Breweries between May 1968 and March 1969 was almost 55% greater than during the previous 11-month period. Following the bidding between ROC and Philip Morris for control, the share price of CBL fell back to about \$9 and then slipped to \$6½ in 1970, reflecting the eroding earnings picture facing the brewery.

Rothmans' stock did not respond in the same manner. Investor interest was aroused with the June 1968 move to invest in CBL, and share prices moved from \$22 to \$30. Over the next nine months, however, the stock drifted down to about \$18½, possibly reflecting concern over further equity dilution if a bid for control of CBL were to be made. Ironically, the May-June bidding for the brewery saw the stock rally from its year's low to over \$27 as investors speculated that RPM would accept the Philip Morris offer. By 1970, the effects of the additional dilution, a tobacco promotional war, and a poor investment environment, resulted in the stock plummeting to \$8 1/8. Following is a year-by-year account of action in both stocks between July 1970 and November 1975.

July 1970 - June 1971. A successful introduction of Heidelberg beer in a keg-shaped bottle saw Canadian Breweries Ltd. trade in the \$6½ to \$9½ range. Rothmans' stock rallied from \$8 1/8 to over \$14 in an 8-month period, reflecting the termination of the cigarette promotional war in mid-1970 and a better investment environment. The cessation of common share dividends and the expectation of lower earnings resulted in the stock falling from \$14 in February, 1971 to \$11 by June, 1971.

July 1971 - June 1972. Canadian Breweries was forced by government pressures to withdraw its keg bottle and to conform to the standard industry compact bottle, and the stock fell from \$7½ in July to \$6 by November. On the basis of rumours that the deteriorating U.S. brewing division was going to be sold to a European brewer, and that a large Swiss bank was buying the CBL holdings, the stock rallied 50% from the \$6 level to \$9 by February. In March, management announced its agreement with United Breweries of Copenhagen to brew Carlsberg and Tuborg in North America and, with no resolution of the U.S. problem in sight, the stock slipped to \$7½ by June 1973. However, the rumoured Swiss sale together with improving tobacco margins moved the shares of Rothmans from a low of \$9 3/8 to a high of \$23 by June 1972.

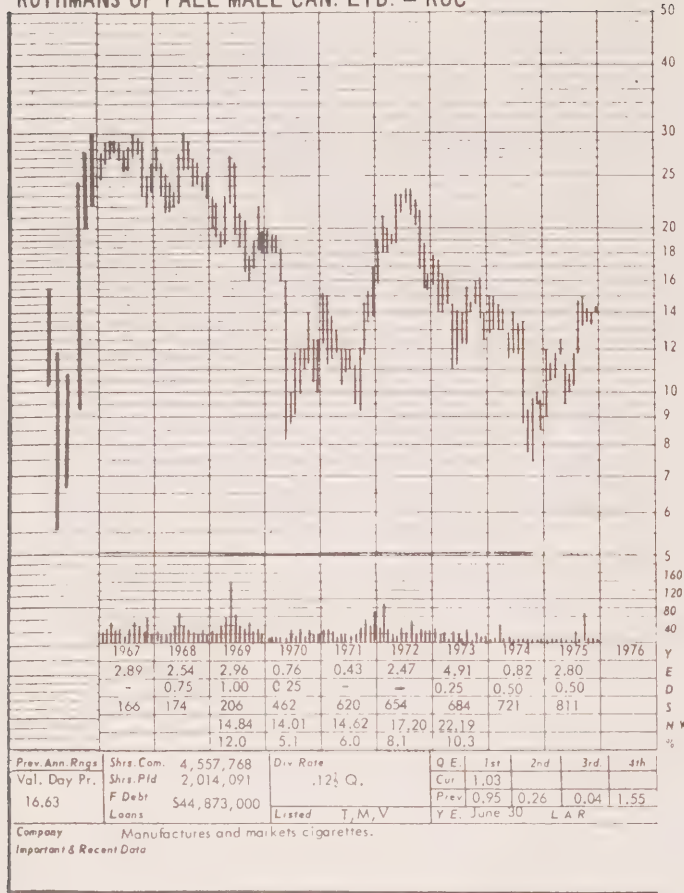
July 1972 - June 1973. The cessation of common share dividends for Canadian Breweries Ltd. in the fall of 1972 resulted in the stock price falling from \$8½ in August to \$5 by December. Further declines in Market share and profits eroded the CBL stock price to \$4 by the end of the June fiscal year. The termination of dividends also had an impact on Rothmans' share prices, and its stock quickly slipped from \$23 to \$16 by December. The losses in the brewing operation, although offset by the tobacco division's growing profitability, brought further investor disenchantment, and the stock declined to the \$10 area by June.

July 1973 - June 1974. In the fall of 1973, a small flurry in the shares of Canadian Breweries Limited--now renamed Carling O'Keefe--was caused by the rumoured sale or termination of brewing activities in the United States, supported by the Tuborg brand introduction failure, the phasing out of two breweries, and the rationalization of sales and administrative offices. However, poor investment environment, together with mounting losses in the United States and eroding profits in Canada, moved the stock from \$5 to \$2½ by June 1974. In sympathy with these events, Rothmans' share prices moved from \$10½ in June to \$16 in late fall of 1973, followed by a quick drop to the \$12 level by June 1974.

July 1974 - June 1975. Once again, a rally in the stock price of Carling O'Keefe took place in the fall, as speculators anticipated a major announcement at the annual meeting in early November. Many U.S. brewers and one prominent Canadian distiller were rumoured buyers and the stock moved from \$2½ to \$3½ per share. Without the termination announcement, it once again fell quickly as the outlook suggested that further losses were likely, and a low of \$1.50 was reached. However, the mounting losses in the United States fuelled speculators' expectations that the Rothmans Group would find these losses totally unacceptable and would force divestiture. On this premise, the stock rebounded from its low to the \$2½ to \$3 range. Once again, a sympathetic price movement occurred in the shares of Rothmans of Pall Mall.

Chart 6

ROTHMANS OF PALL MALL CAN. LTD. - ROC

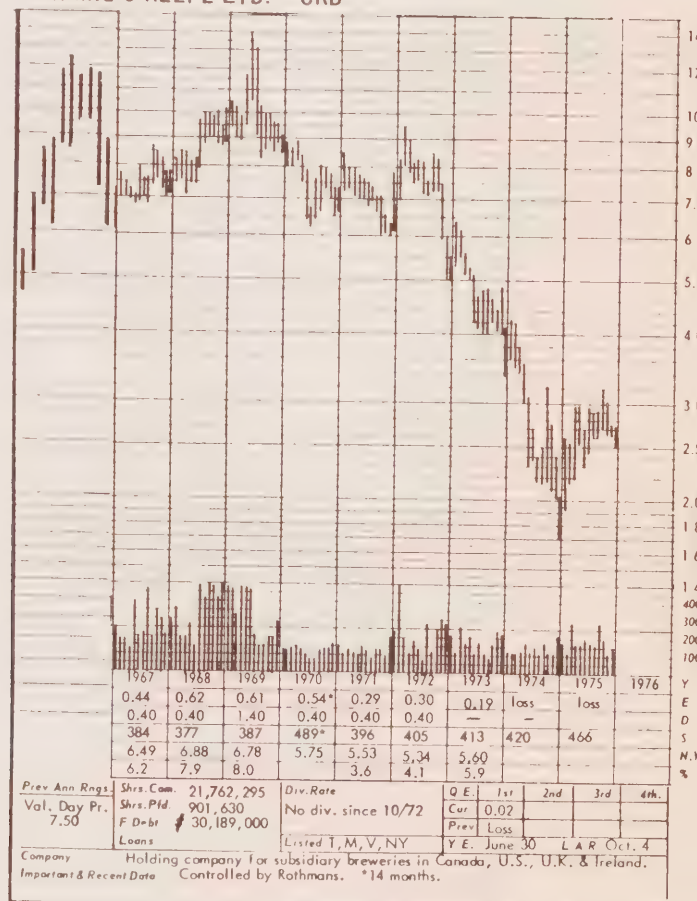


Stock Price

MONTHLY PRICE
MOVEMENT AND VOLUMES
OF SHARES

Chart 7

CARLING O'KEEFE LTD. - CKB



Y - Year
E - Earnings Per Share
D - Dividend
S - Sales
N - Net Worth Per Share
% - Rate of Return

Charts Courtesy of Graphoscope

July 1975 - November 1975. On the basis of an announcement in August that Rothmans was going to write down its investment in Carling O'Keefe by \$71 million, both stocks showed a great deal of activity. Speculators, and now investors, were certain that the long-rumoured disposal of the U.S. brewing interests was going to occur. Once again Carling O'Keefe's management surprised the stock market by announcing its intention to increase its stake in the U.S. beer market by acquiring another regional but marginally profitable brewer. Both stocks fell sharply on this news.

While it is difficult to generalize on the market action of these stocks, it would appear that investors and speculators have misread the intentions of the Rothmans Group as to brewing in Canada and the United States. Also, it is obvious that minority Canadian shareholders would have seen higher earnings and dividend income (hence higher stock prices) had the U.S. brewing interest been terminated. Judging from the financial results, the decision to acquire Canadian Breweries Ltd. in 1968 was the only major fundamental error Rothmans of Pall Mall Canada Limited has made since commencing operations in Canada.

FURTHER ACQUISITION PLANS

Since RPM is controlled by foreign interests, it would have to seek approval of the Foreign Investment Review Agency before diversifying further in Canada through acquisition. To date, not so much FIRA as lack of capital has deterred the company from making such plans. As the balance sheet shows (Table 10), lack of cash and high debt/equity ratio combine to force Rothmans to rely on Carling O'Keefe for diversification growth.

ROTHMANS AS A CORPORATE CITIZEN

Most companies today are aware that their shareholders are not the only ones to whom they have a responsibility, and some therefore involve themselves in community service. Rothmans of Pall Mall has chosen to sponsor certain cultural and sporting events, and has thus earned a fair degree of recognition as a good corporate citizen. However, it is unlikely that the company's support of Rothmans' tennis tournaments, the Craven Foundation, or the Rothmans Art Gallery of Stratford has been anything more than part of an overall marketing program to create brand awareness and brand reinforcement. With government curtailment of broadcast advertising for cigarettes in 1972 and the freezing of advertising expenditures, the tobacco companies have been forced to find such promotional alternatives to keep their brand names in front of the consuming public. Company research indicates that sponsorship pays off--the people who attend the various sponsored events tend to correspond to the profiles of typical consumers. Late in 1975, however, the government announced that it regarded even sponsorship as a marketing effort, and Rothmans is reducing expenditures in this area, as are other tobacco companies.

Table 10

ROTHMANS OF PALL MALL CANADA LTD.

BALANCE SHEET NET OF BREWING OPERATIONS

(Estimated*, March 31, 1977)

<u>CURRENT ASSETS</u>	(\$MM)
Cash	Ø
Short-term investments	Ø
Accounts receivable	18.7
Inventories	113.6
Prepaid expenses	<u>1.2</u>
Total	<u>133.5</u>
Property, plant and equipment, at cost	59.6
Less: accumulated depreciation	<u>30.5</u>
	<u>29.1</u>
Investments and other assets	<u>0.8</u>
	<u><u>163.4</u></u>
 <u>CURRENT LIABILITIES</u>	
Bank loans	48.2
Notes payable	Ø
Accounts payable	12.5
Income taxes	3.2
Other taxes	<u>13.6</u>
	77.5
Deferred income taxes	6.4
Long-term debt	<u>26.3</u>
Total liabilities	110.2
Shareholders' equity	<u>51.2</u>
	<u><u>163.4</u></u>

* - Based on RPM & CBL annual financial statements.

Another form of corporate responsibility that should be recognized by the company devolves from its character as an arm of a multinational. More and more, multinationals are being forced to accept partial responsibility for the social and economic fabric that they weave, and to allow the priorities of a host nation to take precedence over those of the corporation. As a publicly owned subsidiary of a multinational group, Rothmans of Pall Mall takes on an additional responsibility to the minority shareholder, the Canadian public.

Assessment of Rothmans' worthiness as a corporate citizen therefore becomes complex and at times subjective, but can be judged to some degree by looking at the company's impact on minority shareholders, on the Canadian economy, and in the public domain.

TREATMENT OF MINORITY SHAREHOLDERS

From the perspective of financial disclosure, the minority shareholder has little reason to criticize Rothmans' management. Beginning with their information circular in 1963 for the takeover of Rock City Tobacco Company (1960) Limited, throughout the takeover documents for Canadian Breweries Limited, to their annual reports, the disclosure policy has been outstanding. The Company's annual report has been a consistent winner in the Financial Post's Annual Report Awards. Shareholders and prospective investors are treated to a well documented, clear presentation of financial statements and management analysis of the operating results. Financial analysts have, from time to time, been slightly critical of the "burying" of the U.S. brewing results into the consolidated report; however, realistically one must be aware of human sensitivities in light of this division's operating results. All in all, when compared to the disclosure policies of some other diversified companies, the annual report of Rothmans of Pall Mall of Canada Limited is very close to being excellent.

Some minority shareholders have been voicing displeasure about Rothmans' management since the company turned down the Philip Morris bid for Carling O'Keefe in 1969 (see page 22). From their point of view, this decision was a poor one because it caused them to lose capital appreciation on their investment and at least some dividend income. The pouring of new money into the loss-ridden American breweries since 1973 has further fuelled their resentment. Just when they expected divestiture, National Brewing was acquired.

A great deal of this criticism rises from the public belief that major business decisions are made with the interest of the major shareholder, the Rothmans Group, in mind (see page 25). A review of treatment of minority shareholders in the various takeovers results in a mixed verdict. In 1963 the Rothmans Group would not vote in favour of the takeover of Rock City Tobacco Company (1960) Limited unless the majority of public shareholders were in favour of the acquisition. However, the decision to acquire a 50% interest in Canadian Breweries Limited rather than accepting the Philip Morris bid was made by the Rothmans Group after consultation with RPM's management.

Had the company not invested in CBL, the minority shareholder probably would have had little to complain about, as the operating results in the tobacco business have been outstanding (Table 11).

Table 11

EARNINGS OF ROTHMANS OF PALL MALL, 1970-77

(Millions of dollars)

<u>Year</u>	<u>Tobacco</u>	<u>Brewing</u>	<u>Consolidated*</u>
1970	4.8	11.3	1.3
1971	6.5	7.6	2.3
1972	9.4	8.5	5.0
1973	11.5	6.1	6.0
1974	12.6	(5.4)	1.3
1975	17.3	(0.7)	11.2
1976**	21.7	(0.6)	21.1
1977	18.0	1.3	19.3

* - Net for common shares after minority interest in Carling O'Keefe and preferred dividends are deducted.

** - 1970 to 1975 June 30 year end; 1976 & 1977 are March 31, year end.

CONTRIBUTION TO THE CANADIAN ECONOMY

Rothmans' management is not known for participation in Canadian politics or in major decisions affecting the Canadian economy. The company has spent about \$120 million on plant and equipment since 1966--\$85 million in brewing (about 3.3% of sales)--and \$35 million in tobacco (about 4% of sales). By comparison, capital expenditures by business in Canada on average totalled about 13% to 14% of sales.

Whether the company, as part of a multinational, has been a model corporate citizen is difficult to ascertain. The main businesses in which Rothmans is involved do not have a major bearing on the direction of the Canadian economy, and therefore business decisions by the group would have far less effect on the economy than if they were made, say, by Imperial Oil. Nevertheless, some deficiencies are apparent, the most important being the failure to successfully deploy Carling O'Keefe's large cash position in Canada. Almost half of the \$130 million on hand in 1969-70 disappeared in the futile efforts of turning the U.S. brewing subsidiary around, thus losing to Canada potential employment and expenditures on goods and services.

Another policy that slightly tarnishes Rothmans' corporate citizenship is that of instituting price increases in anticipation of rising prices. However, it should be noted that the company is a price follower, not a price leader. In recent years dollar sales and

profit growth have outstepped unit volume gains, and unfortunately not all the improvement can be attributed to greater efficiency. Under AIB guidelines, the tobacco industry no longer raises prices in anticipation of cost increases.

The brewing operations have had the opposite experience with prices, as they have had to absorb costs for prolonged periods and wait approval of the liquor boards for relief by way of price increases.

INVOLVEMENT IN THE COMMUNITY

Because it produces and markets consumer products under widely known brand names, Rothmans of Pall Mall Canada has a high public profile. The company's sponsorship of cultural, sporting and community events, while promotional in nature, does give the company a responsible public image. For instance, the company is a major sponsor of the World Wildlife Fund (Canada), an organization whose goal is to protect endangered species of animals. It should be noted, however, that this particular organization is a personal favourite of Anton Rupert, the head of the Rothmans Group, and that Mr. Rupert is a trustee of the fund.

While it is likely that Rothmans is more responsible to Canadians than are many other corporations, it could be said that the company is not fulfilling its responsibilities, especially in the area of medical research on the health problems related to its products. Rothmans does participate in health research through its involvement in The Canadian Tobacco Manufacturers' Council, which funds various programs. However, an undertaking in this area would probably be construed by some to mean that Rothmans is admitting that tobacco causes cancer and/or beer is responsible for alcoholism. Such an admission would obviously be unacceptable to any company, and especially to a marketing company whose goal is to maximize consumption, not to moderate it.

CONCLUSION

Within the tobacco industry, the concentration of power appears to rest with the federal and provincial governments, both of whom have a large say in the control and sale of tobacco products. While the industry is oligarchic in nature, competition appears to be very keen. Undoubtedly, the concentration of market share among four competitors, together with a very high degree of government regulation, deters entrance into the market.

Without a clearly defined meaning for "corporate power" it is difficult to say that Rothmans of Pall Mall is a concentration of corporate power. In the tobacco industry, the company's success record is quite enviable; however, its acquisition program has met with numerous problems and has negated much of its potential impact on the Canadian economy.

CHAPTER 3

CARLING O'KEEFE LIMITED

This chapter reviews the second of the major companies to be analyzed in this report, Carling O'Keefe Limited. Because of the Royal Commission's special interest in the ethics of acquisition, most of the discussion centres on purchases made by the company over the course of the last 35 years.

However, first the company is looked at in the context of the Canadian brewing industry to show how it operates in the face of strict government regulation and stiff competition. Succeeding sections set out the details of acquisitions in various periods, and a concluding part considers social responsibility.

THE CANADIAN BREWING INDUSTRY

The Canadian brewing industry is comprised of four public companies and two private companies that together operate 43 breweries across the country. Approximately 106 brands are sold by these companies, and 1976 sales totalled over \$700 million, net of excise taxes. During the last half of the 1960's, beer sales increased about 4% annually. The coming-of-age of the postwar babies and the lowering of the drinking age resulted in a 5.5% annual rate of growth between 1970 and 1973, but demand has been virtually flat for the last three years due to cool weather and consumer price resistance (see Table 12). If one word can describe the industry, that word is "controlled". Breweries are regulated by provincial and federal authorities almost as closely as utilities, and failure to operate within the confines of the regulations is not tolerated. For instance, no fundamental aspect of marketing escapes government regulations. The various provincial liquor authorities regulate prices, promotion, packaging, and product distribution. In these areas the brewer must operate within the guidelines or face penalties ranging from fines to suspension of sales. Within the confines of the marketing restrictions, competition is intense.

Between 1966 and 1970, Carling O'Keefe dropped from No. 1 position and John Labatt Ltd. became leader (Table 13). The market share decline occurred when a number of heavy beer consumers died in 1964 over an 8-12 month period in Quebec City, and a rumour in the press related their deaths to Dow beer, a brand made and marketed by a Carling O'Keefe subsidiary. Although the rumour was unfounded, Dow's national image was severely damaged. At about the same time, the Labatt penetration program was in full swing and was especially successful in capturing the brand loyalty of the youth market.

Table 12
GROWTH IN BEER CONSUMPTION
IN CANADA, 1966-76

<u>Year</u>	<u>Total Consumption</u> (Million gallons)	<u>Increase</u> (%)	<u>Adult</u> <u>Per Capita</u> <u>Consumption</u> (Gallons)	<u>Increase</u> (%)
1966	298.2	-	25.2	2.4
1967	306.2	2.7	25.2	
1968*	312.7	2.1	25.1	
1969	329.5	5.4	25.7	2.4
1970	344.3	4.5	27.3	6.2
1971	366.5	6.5	28.5	4.3
1972	384.0	4.8	29.3	2.8
1973	409.5	6.0	30.5	4.0
1974	418.8	2.3	30.6	0.3
1975	429.3	2.5	30.6	0.0
1976	428.5	-0.1	30.0	-0.2

* - Strike in Ontario

Source: Canadiar Brewers' Association

Table 13
CANADIAN BREWERY COMPANIES*
NATIONAL MARKET SHARE, 1966-76E

	(Per cent)										
	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971E</u>	<u>1972E</u>	<u>1973E</u>	<u>1974E</u>	<u>1975E</u>	<u>1976E</u>
Carling											
O'Keefe	40.2	37.3	35.2	32.3	31.2	30.0	29.0	28.0	25.9	25.6	25.0
Molson's	28.7	29.1	29.3	29.4	29.0	30.1	30.3	30.7	34.0	34.4	34.6
Labatt's	24.2	26.1	28.3	30.5	32.1	34.3	35.3	35.7	35.9	35.6	38.0
Regionals	6.9	6.0	7.2	7.4	7.7	5.6	5.4	6.0	4.2	4.4	2.4

* - Based on gallonage sales.

E - Estimated.

Source: Research Company of America - 1966-70
R.G. Shoniker & Associates Inc. - 1971E-76E

The 1968-69 takeover by Rothmans of Pall Mall did not prevent further erosion of the Carling O'Keefe market share by the other two major brewers. Over the past three years, Labatt's and Molson's have augmented their market shares by acquiring three of the remaining independent breweries. Now, except in the Maritimes and Ontario, independents are no longer a factor in the market.

Over the last decade, well-financed foreign companies have indicated the desire to enter the brewing industry, but after investigating the Canadian market many of them have dropped all plans because of the complexity of regulations and the lack of free-spirited marketing. Only Henninger Brewery Ontario Ltd. has entered the market in the last five years, and its financial record is mediocre due to the company's inability to penetrate the highly regulated market.

MARKETING STRATEGY

In a market where producers cannot be differentiated by price, packaging or distribution, promotion is the important variable, and the degree of regulation governing promotional efforts is increasing. At the federal level, brewers are facing growing disapproval of their advertising content, especially when advertisements promote the relationship between drinking and desirable lifestyles. Provincially, advertising guidelines have been revamped in Ontario, Quebec and Manitoba, limiting media exposure and sponsorship of cultural and sporting events, as well as regulating advertising content. While these measures hamper marketing efforts, the forced reduction in advertising could ultimately decrease the cost of marketing as a percentage of sales.

Strategies vary from concentration to proliferation of brands. For example, we estimate that there are in the vicinity of 106 different beer brands available in Canada, of which Carling O'Keefe markets 30, Molson's 27, Labatt's 37 and the independents 12. While all these brands are available at most outlets, promotion usually focuses on a few brands for each company.

PROFITABILITY AND COSTS

The brewing industry has been very profitable over the longer term. Even in the worst of times, as in 1973 and 1974 when brewers were faced with escalating costs and lagging price increases, financial results were quite acceptable relative to those of other manufacturing companies. For example, for the year ending April 30, 1975, Labatt's brewing operations earned a healthy after-tax rate of return of 13.8% on assets employed (versus 14.6% for the previous year).

The single largest factor adversely affecting profits over the last 18 months has been the tremendous increase in the cost of barley. In 1973, malted barley averaged slightly above \$2 a bushel and is currently running

at \$5.60 a bushel. In 1975, it appeared possible that brewers would be able to benefit from falling prices. However, the Wheat Board arbitrarily increased the malting premium from 40¢ a bushel to \$1.02 in order to maintain prices for the farmers and encourage them to plant malting barley. Further arbitrary premium adjustments can be expected if world barley prices fall, because the Wheat Board has a serious commitment to the development of malting barley. Brewers are not allowed to buy futures in barley, and import restrictions prevent them from taking advantage of falling world prices. Actually, though, the prospects for falling prices of grain commodities are slim, as once again demand is likely to outstrip supply.

In Table 14, costs per barrel of beer are compared between the years 1972 and 1976.

Table 14

COSTS PER BARREL OF BEER PRODUCED

IN CANADA, 1972 and 1976

	<u>1972</u>	<u>1976</u>
Barley & grains	\$ 2.09	\$ 5.60
Other ingredients	1.04	2.40
Packaging	4.03	6.62
Maintenance	0.52	0.70
Production wages	3.48	6.55
Fuel	0.38	0.90
	<u>\$11.54</u>	<u>\$22.77</u>
	=====	=====
Brewer's selling price	\$30.82	\$44.00
Gross margin	\$19.38	\$21.23

Source: Statistics Canada, Catalog No. 32.205, 1972.
R.G. Shoniker & Associates Inc., 1976E

PRICE REGULATION

The brewers have been participating in a controlled industry for many years. In all provinces but Quebec price increases must be justified to regulatory authorities, and the resulting time lag is the brewers' biggest problem because anticipation of cost increases is very rarely allowed.

Despite such regulation, profit margins vary greatly. As the companies, by and large, do not follow a policy of full disclosure, we have attempted to estimate the pre-tax profit margins of their brewery divisions over the past five years (see Table 15).

Table 15

ESTIMATED PRE-TAX PROFIT MARGINS OF
CANADA'S LARGEST BREWERS, 1971-75

	<u>Molson Breweries</u> <u>of Canada Ltd.</u>	<u>John Labatt</u> <u>Ltd.</u>	<u>Carling O'Keefe</u> <u>Ltd.</u>
1971	10.55%	14.10%	5.65%
1972	11.59	14.00	4.83
1973	11.17	12.04	4.82
1974	9.22	10.04	1.15
1975	7.00	8.45	3.29

Source: R.G. Shoniker & Associates

POLICIES FOR GROWTH

From 1930 to 1975, Carling O'Keefe Ltd. (Canadian Breweries Ltd. until 1973) played a large part in rationalizing the Canadian brewing industry through the acquisition of many small brewing companies in Ontario and Quebec. Details of these acquisition programs are discussed in this section, together with related events that seem relevant to the Royal Commission's enquiry. For reference purposes, the section is divided into four periods, as follows:

- Acquisitions under E.P. Taylor, 1930-46;
- Purchases between 1946 and 1968, while Carling O'Keefe was controlled by the Argus Corporation;
- The 1954-60 Combines case, in which Carling O'Keefe was cleared of allegations arising from its acquisition program;
- The divestiture and acquisition program after Rothmans acquired control in 1969.

ACQUISITIONS UNDER E.P. TAYLOR

Through a series of acquisitions the original company, Canadian Breweries Limited, which was chartered in Ontario in 1930, brought rationalization to the Canadian brewing industry. In 1930 alone, 10 brewing companies were acquired through share exchanges, including Carling Breweries Limited. While another six brewing companies were purchased in this period, CBL terminated operations in at least five breweries in Ontario and Manitoba, merged eight of its companies and surrendered the charters for another five companies.

During 1933, the company licensed the Peerless Motor Car Corp. to brew and market Carling beer in the United States. By 1944, CBL had a 99% interest in Peerless, which was renamed twice and is now Carling National Breweries, Inc.

The driving force and master mind of this acquisition program was Mr. E.P. Taylor, who later became a well known industrialist and participant in the Argus Corporation Ltd. In expanding the original business, a number of small companies in the soft drink, malting and seed-processing industries were acquired.

The rationalization of breweries caused unrest in the industry, especially in smaller communities (i.e., Brandon, Welland, London) where production facilities were being phased out immediately after acquisitions. In the increasingly competitive environment and the economic climate of the 1930's, Canadian Breweries Ltd. purchased many "bargains" some of which were disputed in the courts. The court actions, however, had little effect on the growth of CBL.

The company's most rapid period of growth occurred after 1946, when Mr. Taylor's interests, approximately 303,000 common shares or 12% of the outstanding and issued capital stock, were sold to Argus Corporation for an undisclosed price (Table 16). Thus, control was transferred to this newly created holding company.

Table 16

ARGUS PURCHASE OF COMMON
SHARES OF CANADIAN BREWERIES LTD.

<u>Year</u>	<u>CBL Common Shares Transferred to Argus Corp.*</u>	<u>Cumulative Holding by Argus</u>
1945	221,290	221,890
1946	81,110	303,000
1947	27,000	330,000
1948	20,000	350,000

* - Does not reflect 5 for 1 split on March 9, 1962.

ACQUISITIONS FROM 1946 TO 1968

Six acquisitions were made during the period 1946-68, when Carling O'Keefe was under the influence of the Argus Corporation. Despite recently acquired interests with the name "Carling", the company was still known as Canadian Breweries Ltd., and will be referred to as such throughout this section.

Dominion Malting Company Limited

In early 1946 Canadian Breweries Ltd. acquired effective control of Dominion Malting Co. Ltd., a major supplier of malt, to ensure adequate supplies

of barley malt (in 1945 shortages of malt had occurred due to a poor crop and increasing demand). About 86% of the common stock was purchased for \$1,949,128 (\$29 a share), and the stock traded in a price range of \$17-\$30 in 1946. For the fiscal year ending July 31, 1946, the company earned 94¢ a share and paid a dividend of 80¢ a share. Dominion Malting's book value was about \$1.7 million or \$21.80 per share.

During this same time period, its chief competitor, Canada Malting Co. Ltd., was trading in a price range of \$52-\$62 on earnings of \$2.92 per share. Its book value was \$7.5 million or \$37.75 per share.

It would appear that the \$29 a share offer was quite reasonable on the basis that a premium on book value was paid. Immediately after the CBL takeover, Dominion Malting's common share dividend was increased to \$1.00 a share and preferred share dividends were maintained. By 1953 CBL had, through dividends, recaptured about 70% of its original investment. Whether this acquisition was conducted entirely at arm's length is difficult to determine. One hint is that an additional 81,110 common shares of CBL were transferred to the Argus Corporation in 1946. While there is no public record as to source or cost, these CBL shares did represent about 7% of Dominion Malting's preferred stock.

In 1953, Dominion Malting Co. Ltd. became a wholly owned subsidiary, with CBL taking up the remainder of the shares at \$40 per share. Between 1946 and 1952, the company's dividend record remained intact at \$1.00, while earnings rose from 94¢ to \$2.99 a share in fiscal 1952. In spite of the vast improvements in earnings, the stock traded in the \$20-\$25 range until the final Canadian Breweries Ltd. bid. With CBL owning more than 90% of the stock by December, 1952, the stock was delisted; there is no public record of what happened to the remaining minority shareholders' interests.

Due to consolidation, there is also no publicly available record of Dominion Malting's progress, or lack thereof, but it would appear that Dominion Malting's health and welfare was tied to CBL's growth. In November, 1962, CBL did announce that its subsidiary had formed American Malting Inc. to acquire the assets of Perot Malting Co. of Buffalo, N.Y., for \$3 million. While there is no official mention of a divestment of Dominion Malting Co., it appears that this company's assets were sold in 1968 to three different buyers for an undisclosed amount. One of the buyers was George M. Black, Jr., a former president of Canadian Breweries Ltd. and until his recent death, a director of the Argus Corporation. An analysis of CBL's financial statements for that year indicates a selling price of about \$13 million. The sale is believed to have occurred at about the time of RPM's acquisition of 11% of CBL, and it took place with RPM's approval.

Undoubtedly, Canadian Breweries' acquisition of Dominion Malting adversely affected Canada Malting's business to some degree. However, Canada Malting showed continued growth in sales and earnings over the years owing to increased demand for its product by other leading brewers.

CBL's impact on the malting business is difficult to measure as records are skimpy and disclosure was virtually unknown and unheard of in the 1946-60 period.

National Breweries Ltd. (Dow Brewery Ltd.)

In June, 1951, Canadian Breweries Ltd. offered to acquire shares of National Breweries Ltd. on a share exchange basis, apparently because there was insufficient capacity available to CBL in Montreal. National Breweries was a Quebec-based brewing holding company with a checkered earnings record in the 1946-50 period (Table 17).

Table 17

NATIONAL BREWERIES LTD.

EARNINGS RECORD, 1946-50

<u>Year</u>	<u>Net Profit</u>
1946	\$2,709,439
1947	3,096,213
1948	3,009,421
1949	1,910,188
1950	942,667

Book value as at December 31, 1950 was approximately \$16.5 million (\$22.80 per share). The first offer was revised within three weeks to accommodate a better bid for the preferred stock, as follows:

Common Shares: A straight one-for-one exchange--721,372 National Brewing Co. common shares at \$20 (market price of Canadian Breweries shares) = \$14.5 million.

Preferred Shares: \$50 a share cash for one National Breweries preferred share--110,000 shares x \$50 per share = \$5.5 million--and the privilege of buying CBL common shares at \$20 a share.

This revision was the result of representation by certain preferred shareholders of National Breweries who stressed that their stock was entitled to four votes and was noncallable.

The management team of National Breweries also opposed the \$20 million cash-and-share offer by CBL, citing "other interested parties" and the signs of success in regaining their previous position in the industry. They had embarked on a program of plant expansion and improvement in August, 1948 and, by 1950, about \$6 million had been spent.

CBL, however, extended its offer from the original deadline of August 10, 1951, to September 7 and again to October 29, and by November owned 21,320 common shares and 91.6% of National Breweries' preferred stock, or a total of 39.9% of the voting power. In December, 1951, CBL received Superior Court authorization to buy the remaining 8.4% of the preferred shares at \$50. A shareholder successfully contested this move in another court.

While negotiations were going on, CBL made a cash offer to buy one of National's breweries, and the sale went through on October 9, 1951. National was slightly short of cash and sold the brewery for \$3.7 million, but had to lease it back for a year as it also was short of capacity.

By March, 1952, CBL had installed a new management team at National Breweries and a new Board of Directors who represented the Argus interest by inclusion of E.P. Taylor and M.W. McCutcheon. In April, the company suspended the common and preferred dividends of \$1.50 and \$1.76 a share respectively. The minority shareholders loudly protested the deferrals of dividend, especially since National Breweries was making money and had recently seen its cash position augmented by almost \$4 million from the brewery sale to CBL. In May, National Breweries' name was changed to Dow Brewery Ltd.

By means of the suspension of the common dividend, CBL forced out another 20% of the common stock and the rest of the preferred stock by 1954, but there are no public records of the dollars exchanged for the shares. By 1964, the company owned over 99% of the common stock, but once again there is no publicly available record of the price paid over the intervening years. Dividends were not resumed.

Western Canada Breweries Limited

The Financial Post card for Western Canada Breweries Limited states that sometime before 1950, Canadian Breweries Ltd. became controlling shareholder of Brewers & Distillers of Vancouver Limited; however, there is no record of a takeover bid for stocks. In January 1950, Brewers & Distillers became controlling shareholders of Western Breweries Limited with the purchase of 243,759 common shares (90.5%) of the total outstanding common shares at \$31.50, or \$8 million, through a tender offer. The funds were raised through a mortgage issue and a convertible debenture issue of equivalent size, yielding 4½% and 5% respectively.

Western Breweries was a holding company that had brewing operations in Winnipeg, Saskatoon and Regina, with profits running about \$1 million a year and the balance sheet showing a book value of about \$5 million. During 1949, the stock traded between \$21 and \$31. After the takeover the two companies were merged and renamed Western Canada Breweries Limited with various operations in British Columbia, Manitoba, and Saskatchewan. There was no sign of management opposition to the takeover, and cursory analysis suggests that the purchase price was reasonable. By July, 1951, all the outstanding shares of Western Canada Breweries Limited had been acquired for \$31.50 a share. Mr. E.P. Taylor and Mr. M.W. McCutcheon joined the Board of Directors in October 1950.

Over the next two years, CBL increased its holding to 76% of the equity of Western Canada Breweries. The stock had traded in the \$32-\$35 range but no indication was given of the purchase price. In late 1962, CBL offered to purchase the remaining shares outstanding at \$36 a share and, by January 1963, the company held 98% of the stock. The Companies Act (Canada), now Canada Corporations Act was then invoked to acquire the remaining shares. At December 31, 1962, book value per share was about \$34.

Between 1947 and 1949, dividends of 60¢ a share were paid annually. With the CBL involvement in 1950, the payout was increased to \$1 a share. The rate was changed to \$1.20 in 1956 and was paid until the suspension of the stock in 1963.

From 1950 onwards, the Western Canada Breweries' balance sheet items noting advances and investments in subsidiaries and associated companies increased significantly, as follows:*

<u>Year</u>	<u>Investment</u>
1949	0
1950	\$1,442,615
1951	n.a.
1952	n.a.
1953	n.a.
1954	5,698,229
1955	6,275,479
1956	6,202,042
1957	6,405,135
1958	6,928,130
1959	6,963,988
1960	6,888,008
1961	5,879,312
1962	6,061,694

While the details of these investments are unknown, there was some speculation that some of the funds were intercorporate borrowings or advances from Western Canada Breweries to Canadian Breweries Ltd.

Old Comrades Brewery Ltd.

In April 1952, Canadian Breweries Ltd. reported that it had acquired the inventories and kegs of Old Comrades Brewery Ltd. of Tecumseh, Ontario at book value plus 302,330 shares at 25¢ a share. The Old Comrades' fixed assets were then leased by a CBL subsidiary with option to buy at \$250,000 by June 30, 1957. While the validity of this sale was questioned by some shareholders, the court action never materialized as the dissidents failed to appear. However, not all shares were tendered. In 1964, CBL arranged a trust fund for the remaining minority interest equivalent in price to 25¢ a share plus interest since 1952.

The company was wound up in 1972, after being inactive for years.

* - Western Canada Breweries Financial Statements.

The Peller Brewing Company

In November 1953, CBL acquired a majority interest in the Peller Brewing Co. Ltd. of Hamilton for an undisclosed sum. An offer was made to purchase the remaining common stock at \$25 per preferred share and \$4 per common share with the offer expiring January 29, 1954.

While Peller was a public company, there is no record of its financial history, or of the CBL offer in any of the normal sources of information. Hence, the value of the transaction is unknown as are subsequent events concerning Peller.

It appears that the company's brewing operations terminated in the Hamilton plant in the 1960's. The plant was bought by Henninger Brewing Co. in 1973 for an undisclosed sum.

Calgary Brewing & Malting Co. Ltd.

Through one transaction, in February 1961, CBL purchased all the outstanding shares of Calgary Brewing & Malting Co. Ltd. for an undisclosed sum believed to be over \$7 million. Assets included a brewery in Calgary and control of the Bohemian Maid Brewing Co. Ltd. of Edmonton. As another subsidiary, Western Canada Breweries Limited, owned the minority interest in Bohemian Maid, CBL thus owned 100% of the shares. Once again, there is no record of subsequent events.

The Bennett Brewing Co.

In November 1962, CBL purchased substantially all the shares of The Bennett Brewing Co. Ltd. of Newfoundland for about \$3.4 million. As Bennett was a private company, subsequent events, including tendering for remaining minority interests in Bennett, are unknown and unrecorded.

Other Acquisitions

While associated with Argus, Canadian Breweries Limited also invested substantially in companies outside Canada. The major acquisitions were as follows:

- A \$9.2 acquisition of Griesedieck Western Brewing Company of Belleville, Illinois, in 1955 from private investors.
- Exchange of shares with Hope and Anchor Breweries Ltd. of Sheffield, England, for a minority interest in Hope and Anchor in 1958. CBL offered 38,724 common shares, valued at \$1.2 million, for 324,556 common shares of Hope and Anchor.
- Purchase of the assets of Heidelberg Brewing Company in Tacoma, Washington, in 1959 for \$3.5 million.

- Purchase of a 40% interest in John Jeffrey & Co. Limited of Edinburgh, Scotland, in early 1960 for an undisclosed sum. This company was merged with Hope and Anchor to form United Breweries Ltd.
- Formation of Hare Place Investments in 1961 to acquire holdings in the U.K. brewing industry. Hare Place was 46% owned by CBL and 54% owned by Charrington Breweries Ltd., a major U.K. brewer.
- Formation of Associated Bahamian Breweries Ltd., in April 1962 to build and operate a plant in Nassau.
- Purchase of 93% of the outstanding shares in Beamish and Crawford Ltd., an Irish brewing entity for \$1.8 million in October, 1962.
- Merger with United Breweries and Charrington Breweries Ltd. in 1962, with CBL owning a 10% interest in the resulting entity.
- Acquisition of the assets of Arizona Brewing Co. Inc., by the Carling Brewing Company Inc. in 1964, for an undisclosed sum.

DIVESTMENT OF CANADIAN EQUITY & DEVELOPMENT CO. LTD.

In February 1968, CBL sold its (undisclosed) interest in Canadian Equity & Development Co. Limited (CEDC) for a reported profit of \$3.3 million. CEDC was a major Toronto real estate holding and development company controlled by E.P. Taylor. The divestment occurred at about the same time as Mr. Taylor was liquidating a number of his Canadian investments in preparation for his departure to the Bahamas. Ownership, including E.P. Taylor's and CBL holdings, was sold to a consortium of investors including Cemp Investments Limited, Cadillac Development Corporation Limited and Canadian General Securities Limited. Later, CEDC was merged with Cadillac Properties and Fairview Corporation to become one of the largest developers in Toronto.

CBL retained notes amounting to an undisclosed amount from this sale. These notes were sold in 1971 by CBL for an additional profit of \$3.5 million as part of RPM's asset liquidation program for CBL.

COMBINES INVESTIGATION, 1954-1960

During 1954, the government's Director of Investigation and Research, acting under the Combines Investigation Act, completed an inquiry into the manufacture, distribution and sale of beer in Canada. The statement of evidence prepared by the Director contained certain allegations against CBL that the company considered unfounded, i.e., that the company had followed a deliberate plan of acquiring rival brewing companies and closing, selling or dismantling a number of their plants in order to eliminate competition and to dominate the industry in Canada. In 23 years, Canadian Breweries Limited was said to have bought 23 rival operations in Ontario and closed the breweries of 12 of them. The number of acquired brands marketed was reduced to 9 from 150. As a result of the acquisition program, the company owned more than 60% of the brewing industry in Ontario and more than 50% in Ontario and Quebec combined.

CBL stated that its merger helped clean up the brewing industry and produced a better product for the consumer, and that its practices were in line with those of its competitors.

Towards the end of 1954, a hearing was held before the Restrictive Trade Practices Commission which, in 1955, made four recommendations to the Minister of Justice intended to prevent further acquisitions, or other alleged practices, that might lead to control of the Canadian brewing industry.

By November 1957, the matter had been referred to counsel by the Minister of Justice with instructions for prosecution. The Crown's case was based on the theory that, since 1930, Canadian Breweries Ltd. had embarked upon a financial scheme to merge companies artificially in such a manner as to eliminate all substantial competition and to obtain for CBL an increasing measure of control and dominance over the policies of the industry, with the aim of obtaining maximum profits on the operation. The case was tried before the Supreme Court of Ontario, and a "not guilty" decision was delivered on February 8, 1960, by Chief Justice McRuer.

Canadian Breweries Ltd. had been charged, under the Combines Investigation Act, of being a party to a merger that "has operated, or is likely to operate, to the detriment or against the interest of the public whether consumers, producers or others".* The Chief Justice concentrated on reviewing the charge as it related to "the interest of the public". Since the provinces constitutionally had jurisdiction and control of the sale of liquor within their boundaries, and the authority to fix its prices and the conditions under which it might be sold, he ruled that CBL was not guilty of restricting price competition or of controlling the practices of the sale of beer. While he acknowledged that CBL controlled the market, the fact that competition existed from Molson's and Labatt's was sufficient to negate the charge of restricting the number of brands available to the public. Chief Justice McRuer also felt that it was not an offence against the Combines Act for CBL to acquire the business of another brewer merely to eliminate a competitor, unless the acquisition appeared to be against the interest of the public. Since, in his opinion, CBL's program of acquiring, closing, selling and dismantling breweries neither brought permanent injury to the public nor destroyed the competitive process within the industry, the case was closed.

THE INVOLVEMENT OF ARGUS CORPORATION IN CBL - A SUMMARY

During the time that Carling O'Keefe was controlled by the Argus Corporation (1946-1968), the company continued a program of domination of the Canadian brewing market through acquisition; extended its strategy of acquisition to make the company an important factor in the U.S. brewing market, and embarked on a plan to become a major participant in the fraction-alized U.K. brewery market.

* - Transcript - Regina vs. Canadian Breweries Limited,
(Vol. I, 26 C.C.C., p. 133.)

Some of the tactics involved in the Canadian acquisitions might be referred to at best as questionable by today's standards (as in the takeover of National Breweries). With accounting disclosure laws virtually unheard of at this time, it is difficult to assess the arm's-length nature of some of the investments, especially those of Western Canada Breweries Limited, and CBL's own investment in Canadian Equity and Development Co. Ltd.

The program of acquisition in the Canadian brewing industry succeeded in adding significant amounts of market share and earnings to CBL for a limited period of time. By the mid 1960's, the company was having market share and earnings problems in both Canada and the United States. (See Table 18 for the earnings record during this period.) While under Argus control, therefore, CBL perhaps was more an example of a favourable investment than of good management.

It is difficult to judge whether CBL's domination of the marketplace deterred new competition from entering in the 1950's and 1960's. In Canada, the degree of competition continued to be fairly high, in spite of the Argus inspired program of consolidation through acquisition. Certainly the success of John Labatt Ltd. in the Canadian brewing industry in the 1960's suggests there was an excellent opportunity for other companies to achieve sales and profit growth in spite of CBL's size.

Table 18

CANADIAN BREWERIES LIMITED

NET INCOME, 1945-68

<u>Year End</u> <u>Dec 31</u>	<u>Net Income</u> <u>(\$MM)</u>	<u>Year End</u> <u>Dec 31</u>	<u>Year End</u> <u>Apr 30</u>	<u>Net Income</u> <u>(\$MM)</u>
1945	2.3	1957		11.3
1946	4.7	1958		10.1
1947	6.5	1959		12.4
1948	6.8	1960		13.8
1949	6.6	1961		14.4
1950	5.1	1962		15.8
1951	5.2	1963		17.2
1952	5.3	1964		16.6
1953	7.7	1965		11.3
1954	7.9		1966*	4.6
1955	10.6		1967	11.9
1956	9.7		1968	15.8

* - Six months only

Since the brewing side of the business continued to decline in the 1970's, the sale of Argus Corporation's interests in CBL to Rothmans of Canada in June 1968 was timely, at least from the point of view of Argus management. Coincidentally, E.P. Taylor left Canada about that time and terminated his active involvement in the Argus Corporation.

AFTER ROTHMANS'
TAKEOVER, 1969 to 1975

The first step in the revitalization program was for Rothmans to liquidate some of Carling O'Keefe's* larger investments in order to be ready for future opportunities. During fiscal 1971, RPM liquidated Carling O'Keefe investments in the United Kingdom and sold land and securities in Canada to net \$43.4 million. As of June 30, 1971, Carling O'Keefe had cash and short-term investments totalling about \$55 million, and its debt/equity ratio was 35%. The company had the ability to raise an additional \$40 million in debt.

During the next 18 months, Carling O'Keefe purchased:

Phillips Brothers Oil & Gas Ltd.	for \$13.5 million
Doran's Brewing Co.	" 3.8 million
Gramercy Holdings Ltd.	" 19.0 million
Growers Wine Co.	" <u>10.4 million</u>
TOTAL	\$46.7 million

Through these acquisitions, the company swallowed a minor competitor in the brewing business, became a major factor in the wine business, and entered into a totally unrelated industry (oil and gas). The acquisitions also introduced the company to the auto plastics industry and made it, in a very minor way, an importer of wines and spirits.

Since June, 1973, Carling O'Keefe had made additional investments in a small soft drink bottling company. It has also acquired a percentage of the minority interest outstanding in its wine operations and, more recently, the assets of a U.S. brewer. These investments have totalled more than \$50 million.

Another deal, though not a physical acquisition, should be mentioned here because of its major impact on the company. In early 1972, the production and marketing rights for Tuborg and Carlsberg beer brands were secured for the United States, Ireland and Canada by an agreement between Carling O'Keefe and United Breweries Limited of Copenhagen.

While carrying out this vigorous program for Carling O'Keefe the management of Rothmans of Pall Mall encountered greater problems than they had originally expected. These, especially the growing losses of the U.S. brewing subsidiary, demanded a great deal of management time and effort, not to mention money. Failure to resolve the brewing problems impeded further acquisitions and drained Carling O'Keefe's financial resources to the extent that the current cash and short-term investment position is probably lower than that most recently reported at March 31, 1976 (\$2.9 million) and the capability to borrow is very limited.

* - For purposes of distinguishing changing control, Canadian Breweries Ltd. under Rothmans' ownership is referred to as Carling O'Keefe Limited, although the actual name change was not effected until November, 1973.

There appears to be no evidence of the use of power by either Rothmans or Carling O'Keefe in the takeovers. Although Carling O'Keefe has, through investment, become a major participant in the domestic wine business, undoubtedly provincial governments have a greater impact on that industry than any brewery-owned vintner, however well financed.

In any case, the rate of return on the company's acquisition program under Rothmans' direction has been very low, as the following figures show.

<u>Acquisition</u>	<u>Original Investment</u> ((\$MM))	<u>Estimated Average Annual Rate of Return on Original Investment</u> (%)
Doran's Brewing Co.	3.8	N.A.
Oil & Gas	13.5	5.2
Wine	29.4	2.4

Since Acquisition to March 31, 1976.

N.A. - not available, as it is a private company.

Undoubtedly, the minority shareholder could probably criticize management for failing to obtain a reasonable rate of return on its acquisition program in Canada. Additional concern has been expressed about the power of the controlling shareholder in that some of the decisions (eg. the decision to acquire National Brewing) associated with the U.S. brewing operations appear not to be made with the best interests of all shareholders in mind.

HARE PLACE, BASS-CHARRINGTON, AND OTHERS

During the summer of 1970, Carling O'Keefe and Bass-Charrington Limited, a major U.K. brewer, agreed to liquidate Hare Place Investments, whose assets consisted of minority interests in various U.K. breweries and cash advances to Bass-Charrington. Carling O'Keefe's interests, at cost, amounted to 46% or \$21,454,000, and the company netted proceeds of \$15,034,000 from the sale. The dollar loss resulted from the decline in the dollar value of U.K. currency over the period during which Carling O'Keefe acquired and held the investment.

Management stressed its desire to retain as much liquidity as possible in order to be able to take advantage of possible investment alternatives.* Hence, funds were invested in short-term notes that emphasized liquidity rather than yield. Minority shareholders of Carling O'Keefe criticized this investment strategy to no avail at the company's annual meeting.

* - Canadian Breweries Limited - 1970 Annual meeting of the shareholders, Report of the Proceedings and the Address of the Chairman of the Board, page 8.

Later in 1970, Carling O'Keefe sold its shares of Bass-Charrington Limited for \$22,914,000. Since the original investment had cost the company \$19,874,000 so that a profit of \$3,040,000 was made on the transaction, the proceeds were once again invested in highly liquid, short-term securities.

From these two disposals, Hare Place and Bass-Charrington, Carling O'Keefe invested approximately \$55 million in foreign short-term securities. Management stated in the press that tax considerations forced off-shore investing by the company.

During fiscal 1971, sundry properties with a book value of \$3.8 million were also sold at a profit of \$2.1 million. In addition, notes receivable from the 1968 cash sale of Carling O'Keefe's investment in Canadian Equity and Development were disposed of for \$4.7 million, a gain of \$3.5 million.

For the year ended June 30, 1971, the company's short-term investments yielded 2.5% (\$2.2 million on \$87.9 million of investments). This poor return was widely criticized in investment circles.

Beamish and Crawford Limited

As part of the divestiture of Hare Place, Carling O'Keefe took over the management of Beamish and Crawford Ltd., which had been acquired in 1962 and managed for the company by Bass-Charrington. Beamish and Crawford was an Irish brewing entity with an extremely poor earnings picture. In 1970, for example, it had a loss of \$425,000; sales were not revealed. By June 1971, the loss had been reduced to \$160,000, from operations on sales of \$9.2 million. A program of market penetration improved results (Table 19) until 1975, when major trading down for ale to cheaper lager adversely affected results.

At present Beamish and Crawford has a small share (a little over 6%) of the Irish beer market, which is dominated by subsidiaries of the large British breweries.

Table 19

BEAMISH AND CRAWFORD LTD.

FINANCIAL PERFORMANCE, 1971-77

<u>Fiscal Years</u> <u>Ended June 30</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976*</u>	<u>1977*</u>
Sales (MM barrels)	165	195	230	250	199	200	182
Sales (\$MM)	9	12.8	15.2	16.9	17.3	18.8	18.9
Net Earnings (\$M)	(160)	360	499	561	246	116	(203)
Earnings per barrel	(0.97)	1.85	2.17	2.24	1.24	0.58	(1.12)

* - March 31, year end.

Phillips Brothers Oil and Gas Ltd.

In June 1971, the company announced the acquisition of Phillips Brothers Oil and Gas Ltd., a privately owned Calgary company. Included in the acquisition was a half interest in Kodiak Oil and Gas Inc., a small U.S. company previously owned by Phillips Brothers. The total transaction amounted to \$13.5 million.

At the time of the acquisition, Carling O'Keefe management stated that it felt the increasing demand for energy would make Phillips Brothers a very attractive investment over the longer term. Probably the oil and gas tax laws of 1971 were an attractive reason for the investments.

Subsequent to the transaction, Phillips Brothers' name was changed to Star Oil & Gas Ltd. During its first year under the control of Carling O'Keefe, a new management was appointed (Mitchell and Associates Ltd.) and the exploration and the acquisition of land increased. Sales of \$1.7 million and net earnings of \$0.26 million were recorded in that year. By June 30, 1973, oil and gas properties had a net book value of \$13.4 million valued at \$20.3 million by an independent petroleum reservoir analysis company.

During fiscal 1974, the company terminated any new plans for exploration and development due to the change in federal income tax that adversely affected the cash flows of the oil and gas industry. In fiscal 1975, management moderated this stance and Star participated in the drilling of nine wells and acquired interests in 18,784 acres of prospective oil and gas lands. During fiscal 1976, Star continued its active program with the acquisition of interests in 23,414 acres of prospective oil and gas lands.

A change in accounting policy during fiscal 1976 from the "conventional" to the full cost method of accounting resulted in a restatement of fiscal 1975 earnings from \$200,000 to \$932,000. Fiscal 1976 produced \$4.8 million in sales revenue and \$2.3 million in net earnings for the company, while fiscal 1977 yielded \$2.4 million in earnings on sales of \$6.1 million. Carling O'Keefe's position is insignificant in the oil and gas industry which is dominated by international companies of much greater size.

Doran's Breweries and Beverage Co.

On August 31, 1971, Carling O'Keefe acquired all the outstanding shares of Doran's Northern Ontario Breweries Ltd. and Doran's Beverage Co. Ltd. for \$3.8 million cash. Doran's, a private, family-owned company, operated four breweries in northern Ontario with a combined capacity of 335,000 barrels. The company was a dominant force in the draft beer market in this area, but has only a minor representation in the packaged (bottled) beer market. Doran's Beverage Co. held the local franchises for Canada Dry, Orange Crush, Pepsi-Cola and Seven-Up, and also produced and marketed its own soft drink line. Prior to the acquisition, sales were estimated at about \$10 million annually, with profits near \$250,000.

Based on price/earnings valuation of 10 to 12 times earnings for small, private beverage companies, the \$3.8 million purchase price paid by Carling O'Keefe appeared generous. Another method of evaluation is capacity. Engineers have indicated that new equivalent capacity for Carling O'Keefe would have cost about \$25 a barrel or \$8 million. However, the Doran plants were old and small and would not have been able to ease capacity problems in southern Ontario, if indeed any had occurred. A fair price might have been \$10 a barrel, or \$3.4 million, with an additional sum for the soft drink franchise. Given the fact that future prospects for a small family-owned brewery in an industry dominated by giants were slim, the offer was probably quite fair.

In the year immediately following the acquisition, Doran's profits were increased by 30%, but no mention of the company has been made by Carling O'Keefe in its annual reports since 1972. It is known that a small soft drink company in Thunder Bay was added to Doran's Beverage in 1973 and it is understood that Doran continued to operate all of its breweries and employed about the same number of people as at the time of acquisition.

In June 1977, Doran's was sold to a group of its employees for an estimated \$4.5 million.

Carlsberg and Tuborg Rights

In the fall of 1971, Carling O'Keefe entered into a long-term co-operative agreement with United Breweries Limited of Copenhagen, the makers of Carlsberg and Tuborg beer, whereby it obtained the production and marketing rights for these two brands in the United States, Canada and Ireland. Royalties were payable in fixed amounts to September 30, 1974, and thereafter were based on total sales of all brewery products at rates varying with volume and selling prices of the products. The agreement is cancellable on 20 years' notice, or earlier if certain conditions (unspecified to the public) are not fulfilled.

Apparently, the main reason for entering into this agreement was the belief of Carling O'Keefe's management that Tuborg, if brewed and priced as a premium beer in the United States, would help bring the American operations into the black. It was also expected that Carlsberg would add to profits in Canada and perhaps prevent further erosion of sales.

While the results with Carlsberg/Tuborg can best be described as mixed, one little publicized fact of the agreement has helped the company. The agreement allowed Carling O'Keefe to have access to the brewing research and technical knowledge of United Brewers. Therefore, during fiscal 1973, the company was able to reduce local brewing research and development activities substantially (to the amount of \$400,000 per year)* as R & D was being done "under assignment in Copenhagen".

* - Canadian Breweries Limited, 1974 Annual Meeting of the Shareholders, Report of the Proceedings and the Address of the Chairman of the Board, page 7.

Gramercy Holdings Ltd. and
Grower's Wine Co. Ltd.

On February 29, 1972, Carling O'Keefe acquired 75% of Gramercy Holdings Ltd. for \$14.4 million cash, with a commitment to acquire the remaining shares from minority shareholders for a minimum of \$4.8 million by the end of fiscal 1978. The company had been sold to Carling O'Keefe and Mr. Torno (a minority shareholder of Gramercy and a noted wine authority), for a total of \$19 million by Distillers Corporation-Seagram Ltd. At that time, sales were estimated to be running at 3 million gallons a year, or \$15 million, while net profit was about \$900,000. In effect, Gramercy stock was sold at 29 times earnings, which was a standard price/earnings evaluation for wine companies in the early 1970's. However, this purchase price was perhaps too generous, as Seagram was allowed to (a) remove the senior management team that had built Gramercy into Canada's leading wine company and (b) re-enter the Canadian wine business in 1973 through the erection of a new plant in Quebec that was going to produce wines from imported grape concentrate rather than from domestic grapes. There was every likelihood that the new Seagram's venture would produce a better product than that of Gramercy Holdings or Jordan Valley, as it was now called.

There were no signs of minority shareholders' displeasure with this acquisition as, by and large, the transaction met approval. The wine industry was regarded as the most exciting sector of the beverage alcohol market in Canada. However, some investment analysts questioned the viability of the investment, given the small dollar size of the Canadian wine market and its major adverse impact on Carling O'Keefe's profitability.

It is difficult to assess the effect of the takeover, as Jordan Valley was fully consolidated immediately after the acquisition. A new management team, headed by Carling O'Keefe former Vice-President of Finance, Peter Zachary, was placed at Jordan, and new marketing programs were developed and new brands introduced.

Before long, Carling O'Keefe was actively involved in discussions with Imasco Limited with the intention of acquiring that company's controlling block of shares of Grower's Wine Company, a western Canada vintner; the transaction was completed in February 1973 for \$10.4 million. At the time, Grower's was earning about \$300,000 on sales of \$7.5 million so that, based on a price/earnings evaluation, the offer was once again almost generous.

Soon after the acquisitions, costs escalated and profit margins fell sharply. A number of cost-cutting measures were introduced including the closing of a winery at New Westminster, British Columbia. The financial performance has been as shown in Table 20. The decline in earnings per gallon reflects higher grape and glass costs and a major increase in marketing expenditures--which were not fully offset by higher prices and sales volume.

With over 30% of the domestic wine market, undoubtedly the company's wine operations would be a force to contend with in an open or free-spirited market environment. However, as with beer, the product is controlled by government authorities. Provincial liquor boards are the consumers, and price

Table 20

JORDAN VALLEY WINES LIMITED

FINANCIAL PERFORMANCE, 1972-77

<u>Fiscal Years</u> <u>Ended June 30</u>	<u>1972*</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976**</u>	<u>1977**</u>
Sales (thousands gallons)	1,103	3,907	4,951	4,698	4,891	4,800
Sales (\$ million)	4.8	18.7	24.4	27.3	30.0	29.3
Net earnings (\$ million)	0.3	0.5	0.7	0.8	1.2	(0.3)
Earnings per gallon (cents)	29.2	13.2	13.8	17.9	24.5	(0.7)

* - Four months only.

** - March 31, year end.

cutting, discounting, and like practices are not found. As the main raw materials (grapes) must be purchased through a provincially sponsored marketing board, and imported concentrate cannot be used until all domestic grapes have been sold, individual companies have little impact on the farmer.

Jordan Valley is rivalled in size by three other companies, T.G. Bright, Andres Wines, and Labatt's, whose wine labels include Chateau-Gai, Chateau Cartier, Casabello and Normandy. Together, these companies dominate the domestic wine market. While well financed subsidiaries of larger companies (Calona Wines of Standard Brands, Maison Secrestret of Seagram's) intensify brands competition, smaller vintners do not have the financial resources to compete successfully over the longer term. The larger companies are able to devote more money to advertising and product research and development, thus enhancing their chances for success.

The greatest competition comes from some of the provincial liquor boards which import, bottle and market their own wine lines at attractive prices. Needless to say, the fact that the No. 1 customer of domestic wine companies is also their competitor is a point of contention in the industry.

National Brewing Co.

In late October 1975, Carling O'Keefe significantly increased its stake in the U.S. brewing market by acquiring the assets and trademarks of The National Brewing Co. of Baltimore. (Major brands: Colt .45, National Premium, National Bohemian and Malt Duck.) The transaction called for a cash payment of \$16.5 million plus a maximum of \$9 million based on a percentage of earnings of Carling National Breweries Inc.--the new firm to be formed by the merger of Carling Brewing and National Brewing--over seven years beginning April 1, 1976.

The acquisition, which was highly unpopular with investment analysts, is described as the first step in a recovery program for the loss-ridden U.S. subsidiary. National Brewing was a family-owned brewing company with sales of about 2.3 million barrels (versus 3.4 million for Carling). While it had breweries in Baltimore and Phoenix, only the Baltimore plant was of a sufficient size to yield economies of scale.

Since the commencement of business, Carling National Breweries Inc., the successor company to Carling Brewing Company Incorporated, has combined and restructured the sales organization and centralized headquarters functions in Baltimore, Maryland. A 1-million barrel brewery in Natick, Mass. has been shut down in an effort to consolidate production.

Critics are quite concerned about the viability of some of National's brands, especially Colt .45 which is a malt liquor, higher in alcohol content than regular beer and often perceived as a maltier, heavier beer. The marketplace has swung very quickly to light, lower calorie beers recently, and Colt .45 is believed to account for more than one-half of National's sales.

Many opponents feel that the consolidation plan is just throwing good money after bad and shows lack of concern for the minority shareholder, who would have recommended the termination of its U.S. investment. They also point out that, if by chance Carling National can grow with the market at 3% for the next two years, a major capacity constraint problem will be encountered in 1978. This problem will call for large capital expenditures and/or the acquisition of another brewery.

The investment community generally thought that the decision to continue operations in the United States emanated from Rothmans of Canada and perhaps even the Rothmans Group. However, it should be noted that the RPM and Carling O'Keefe senior executives pointed out this decision was made solely by the Carling O'Keefe Board of Directors.

CARLING O'KEEFE LIMITED AND SOCIAL RESPONSIBILITY

An assessment of Carling O'Keefe's corporate citizenship cannot be divorced from the previous review of Rothmans' citizenship (on page 31). Under that company's ownership, Carling O'Keefe has had a much higher--and probably better--public profile than in the days when it was dominated by Argus.

The company's active program in the support of amateur sports, cultural events and community affairs is quite impressive, including financial sponsorship of the O'Keefe Sports Foundation, the Carling Community Arts Foundation, and Community Service Caravans. These services began in 1973 with the return of Rothmans' acknowledged marketing leader, Wilmat Tennyson, to Carling O'Keefe's management team. Marketing controls in the brewing industry set by the provincial liquor authorities necessitated a departure from normal promotional activities, and thus the company's program of community and cultural involvement developed. First and foremost, the program can best be described as an integral part of Carling O'Keefe's overall marketing effort and only secondly as a manifestation of corporate social responsibility.

Certainly it is very difficult to assess the level of social consciousness without taking a position on the morality of the products. Both Carling O'Keefe and its parent, Rothmans of Pall Mall, are dominant participants in two highly visible products that bring both satisfaction and at times distress to some of the Canadian public. However, it should be noted that direct concern over health and social problems associated with their product line could be construed by some as an admission of guilt, and such a premise would be totally unacceptable to both companies.

CONCLUSION

Even to a greater degree than the tobacco industry, the brewing industry is an example of the fact that the concentration of corporate power rests with the government, especially at the provincial level. Pricing, distribution and promotion are strictly regulated. Besides the concentration of market share among the three large brewers, myriad government controls have caused companies to abandon plans for entry into this business, and forced others to withdraw from the industry.

By the time of the 1968-69 Rothmans' involvement, Carling O'Keefe was slipping rapidly from a position of dominance in the brewing industry. Rothmans liquidated nearly \$43 million in assets to finance future plans. It would appear, however, that successful deployment of the resulting large cash position was hampered by the problems of the brewing operation. The extension of those problems to the present has considerably reduced Carling O'Keefe's position of influence and stature within the business community.

Financial results suggest that Carling O'Keefe's acquisition program under the Rothmans' umbrella has not been an outstanding success. Return on investment to the company from its diversifications into wine and oil and gas has been low. Moreover, the insurmountable problems of the U.S. brewing division has drained cash (about \$10 million) as well as management time and skills.

From an outsider's perspective, the decision-making process is difficult to assess. For years, press reports have stated, highlighted and strongly hinted that the major decisions at Carling O'Keefe Limited were made by members of the London-based Rothmans Group. As recently as November, 1975, the Toronto Star indicated that management reported directly to London. However, both Rothmans of Pall Mall Canada Limited and Carling O'Keefe Limited's officials state that the Star article is erroneous. A subjective judgment of the individuals at the senior management level at Carling O'Keefe Limited suggests that it is unlikely that the major decisions are made elsewhere; however, one can ponder and speculate how long a majority shareholder will remain on the sidelines if financial results do not improve.

CHAPTER 4

SUMMARY OF FINDINGS

The histories of Rothmans of Pall Mall and Carling O'Keefe, as related in this report, reveal a number of facts that will be of interest to the Royal Commission on Corporate Concentration. These are briefly summarized here, with page references to provide discussions as pertinent.

Influence of Competition

1. Due to the number of regulations and guidelines within the tobacco industry, the real power is concentrated in government, which readily influences price (through excise and sales taxes), promotion and product (page 9). However, it is the current oligarchic nature of the market that deters new competition especially from small Canadian-owned cigarette producers. (Not one of the four companies who dominate more than 99% of this industry is Canadian controlled.)

2. In the brewing industry, government is again the dominant factor. It sets the price and decides what is permissible in marketing programs, such as advertising content, bottle design, media selection, and distribution (pages 37 and 39). In 1974 one brewer sold out after losing \$5 million in three years, feeling that no new company could compete successfully in a marketing environment that was so tightly controlled.

The major factor affecting competition, however, is the concentration of more than 95% of market share in the hands of three brewing companies. Since 1970, four small independent brewers have been acquired by the giants; three remain, none of which has the financial resources to compete against the major brewers for a prolonged period.

Acquisitions

3. The acquisition program of Rothmans of Pall Mall seems to be based on the desire of the Rothmans Group to perform more effectively in the North American tobacco market. Certainly transactions have not always been at arm's-length. (See acquisitions of: Rock City, page 16 Larus & Brother Co., page 20 ; and Alfred Dunhill of London Ltd., page 21 .)

4. When the company was under the control of E.P. Taylor and the Argus Corporation, Carling O'Keefe's acquisition program was conducted at times with questionable tactics by today's standards (see page 50). After Rothmans took over, acquisitions yielded a very low return on investment (page 52).

Corporate Citizenship

5. Failure by Rothmans of Pall Mall to successfully deploy Carling O'Keefe's large cash position and financial resources has had a negative impact on the Canadian economy in that potential employment and expenditures in goods and services have not been realized (page 34).

6. The health and social controversy surrounding the company's products raises questions concerning its corporate responsibility in the minds of some of the Canadian Public (see pages 35 and 59).

Management

7. The low return on investment from the acquisitions made by Carling O'Keefe while under Rothmans' control, together with the continuation of brewing problems, has reduced not only the company's financial resources but also its stature within the business community.

APPENDIX

CANADIAN BREWERIES LIMITED BOARD OF DIRECTORS

COMMON TO

ROTHMANS OF PALL MALL CANADA LIMITED

1968

Joel W. Aldred
C.F.W. Burns
Sir Francis De Guingand
John H. Devlin
John E. Shaffner
W. Tennyson

1972

Joel W. Aldred
Sir Francis De Guingand
John H. Devlin
Robert H. Hawkes
R. St. Laurent
John E. Shaffner
W. Tennyson

1969

Joel W. Aldred
C.F.W. Burns
Sir Francis De Guingand
John H. Devlin
Paul J. Erasmus
R. St. Laurent
John E. Shaffner
W. Tennyson

1973

Joel W. Aldred
Sir Francis De Guingand
John H. Devlin
Robert H. Hawkes
R. St. Laurent
John E. Shaffner
W. Tennyson

1970

Joel W. Aldred
Sir Francis De Guingand
John H. Devlin
Paul J. Erasmus
Robert H. Hawkes
R. St. Laurent
John E. Shaffner
W. Tennyson

1974

Joel W. Aldred
Sir Francis De Guingand
John H. Devlin
Robert H. Hawkes
R. St. Laurent
John E. Shaffner
W. Tennyson

1971

Joel W. Aldred
Sir Francis De Guingand
John H. Devlin
Paul J. Erasmus
Robert H. Hawkes
R. St. Laurent
John E. Shaffner
W. Tennyson

1975

John C. Lockwood

1976

John C. Lockwood

